

PARTNERSHIPS

A Review of Tax Planning Strategies

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A. WHAT IS A PARTNERSHIP

A Partnership is a relation among persons fostered to carry on business. The *Partnership Act*, 1890 (U.K.)² and all of the common law provinces of Canada which have since enacted nearly identical statutes³ have defined a partnership as:

the relation which subsists between persons carrying on business in common with a view of profit.⁴

This definition has been continuously applied by the courts of Canada. In *Backman v. Canada*,⁵ the Supreme Court of Canada confirmed the three essential ingredients of a partnership are:

1. a business;
2. carried on in common; and
3. with a view to profit.

These elements have been examined at length by the courts and the existence of a partnership is often a key point of law in tax cases involving partnerships.⁶ The nuances of the law of partnerships however is beyond the scope of this paper, which instead will survey the tax treatment of partnerships and provide examples of planning opportunities using partnerships.

A partnership must be distinguished from a joint venture which is also a relationship between persons who carry on business in common with a view to profit. Joint ventures are generally distinguished from partnerships on the basis that a joint venture is usually formed to pursue a limited objective, a single undertaking or an ad hoc enterprise.⁷

A partnership is a business organization with at least two members. It is a relationship and not a separate legal entity. This reality has forced the drafters of the *Income Tax Act*⁸ to create specific rules with relation to the taxation of partnerships.

² 53 & 54 Vict., c. 39.

³ See for example *Partnership Act*, R.S.B.C. [1996] c. 348 (the “*Partnership Act*”).

⁴ *Ibid.*, section 2.

⁵ [2001] 1 S.C.R. 367.

⁶ See for example *Gedess Contracting Co. v. R.*, [2005] 1 CTC 2717 (TCC) aff’d by [2006] 2 CTC 241 (FCA), *Eidsvik v. R.*, 2006 DTC 2856 for recent cases regarding the existence of a partnership in a tax related transaction and the trilogy of *Continental Bank*, [1998] 2 S.C.R. 358, *Backman v. Canada*, [2001] 1 S.C.R. 367, and *Spire Freezers Ltd. v. Canada*, [2001] 1 S.C.R. 391.

⁷ For a more detailed discussion on the distinction between a joint venture and a partnership, see 2005 PPC p. 14 Partnerships and Joint Ventures (Cherniawsky, D.)

⁸ R.S.C., 1985 (5th Supp.), c.1. All statutory references in this paper will be to the *Income Tax Act* unless otherwise noted.

Unlike trusts, another relationship amongst persons which lacks status as a separate legal entity, the *Act* does not deem a partnership to be a separate taxpayer. Unlike joint ventures, a partnership is not completely disregarded for income tax purposes. Instead, the *Act* treats a partnership as a separate person for certain purposes and as a flow through entity for all other purposes. A partnership must calculate each source of income at the partnership level as if it were a separate taxpayer. However, the net result, be it income, losses, capital gains or losses or expenses and related deductions, are treated as being received directly by the partners.⁹ Partnerships are treated as a separate person for the purposes of facilitating reorganizations of the partnership into different business structures. A partnership is also treated as a person for a number of specific purposes including the application of anti-avoidance rules and in relation to certain tax incentives.

B. TYPES OF PARTNERSHIPS

The characteristics of a partnership are determined by the agreement amongst the partners who form the partnership and the common law and statutory regime applicable to such partnership. A partnership can exist where a business is carried on in common with a view to profit, even if there is no formal agreement or registration. In addition to the General Partnership which is formed through the actions of the partners, the *Partnership Act* allows for the formation of Limited Partnerships (“LP”) and Limited Liability Partnerships (“LLP”).

1. General Partnerships

As a starting point for understanding partnerships, imagine two individuals, Mrs. X and Mrs. Y, who agree to carry out a business in common. Mrs. X and Mrs. Y will both be partners of the partnership, XY Partnership, and absent any other agreement amongst them, they will share any gains or losses from the business equally. Similarly, as they are carrying on business ‘in common’ they are jointly and severally liable for the actions and omissions committed by of the other partner *qua partner*. Thus, if Mrs. X enters into a contract to purchase supplies for the partnership, Mrs. Y is as liable as Mrs. X to ensure that the contract is completed. This is the model of a general partnership, a business model which works best when all of the partners are actively involved in the business. It can be varied by contract to delegate rights and responsibilities amongst the partners such as who is responsible for various ventures, and to what extent profits from those ventures are shared.

2. Limited Partnerships

A partnership may include a member who wishes to limit such member’s involvement to investing funds in the partnership in exchange for a share of the profits. The partnership statutes of the common law provinces and the Civil Code of Quebec all allow for the creation of limited partnerships (“LP”).

LPs allow for a partnership with two types of partners, general partners and limited partners. General partners play an active role in the management of the LP and continue to have the risks associated with partners in a general partnership. Limited partners limit their risk exposure to the

⁹ Subsection 96(1).

amount invested in the partnership but must forego the right to partake in the management of the partnership.

The B.C. *Partnership Act* limits the liability of a limited partner to the amount that partner invests in the LP.¹⁰ If the limited partner becomes involved in the management of the LP, this statutory protection will be lost and the limited partner will become a general partner and be subject to unlimited personal liability for the obligations of the LP.¹¹ In addition to the three ingredients for a partnership, a LP must also:

1. have at least one general partner;
2. have at least one limited partner; and
3. be registered as a LP under an applicable provincial statute.

Where the general partner of an LP is a corporation, the LP structure can effectively be used as a substitute for a corporation as full liability shield business structure by isolating all of the liability for the partnership business in the corporate general partner. However, limited partners could lose their liability shield if they exercise control over the corporate general partner.¹²

3. Limited Liability Partnerships

The *Partnership Act* allows for the certification of a third type of partnership, the Limited Liability Partnership. A LLP limits the liability of partners in a different manner than the limits created by a LP. Pursuant to section 104 of the *Partnership Act*, a partner in a BC LLP:

- (i) is not personally liable for a partnership obligation merely because that person is a partner;
- (ii) is not personally liable for an obligation under an agreement between the partnership and another person; and
- (iii) is not personally liable to the partnership or another partner for an obligation to which paragraph (i) or (ii) applies.

A partner in a BC LLP will be personally liable for the partner's own negligent or wrongful acts or omissions and for the negligent or wrongful acts or omissions of another partner or an employee if the partner knew of the act or omission and did not take the actions that a reasonable person would take to prevent it.

A BC LLP is considered to be a "full shield LLP" because a partner in BC LLP is shielded from the liabilities of his fellow partners as well as from the liabilities of the partnership.¹³ This can be contrasted with an Alberta LLP, where the limited liability partner is only partially shielded,

¹⁰ *Partnership Act, supra*, section 57.

¹¹ *Partnership Act*, section 64.

¹² See the discussion on Limited Control below

¹³ *Partnership Act*, sections 104 and 105.

that is they are shielded from the liability associated with other partners, but they are still liable for the debts of the partnership.¹⁴ Any BC partnership can apply to convert to a British Columbia LLP,¹⁵ with the exception of professionals who are prevented from having LLP status by their governing organizations.¹⁶ Most other provincial LLPs are specifically restricted in use to partnerships of professionals.¹⁷

The differences between the limits on liability are important for tax purposes since it determines the status of the limited liability partner as a “limited partner” for purposes of the *Income Tax Act*. In particular, limited liability partners of an Alberta LLP are generally not “limited partners” while those of a BC LLP probably are “limited partners” for the purpose of the *Income Tax Act*.¹⁸

C. TAX CHARACTERISTICS

The recognition of a partnership for limited tax purposes set partnerships apart from other business organizations. Partnerships are treated as a separate business and income from the partnership business is calculated at the partnership level even though a partnership is not a separate taxable entity. Partnerships do not file separate income tax returns but file information returns.¹⁹

Net partnership income or losses are allocated to the partners after the end of the fiscal period of the partnership. The partners then are responsible for reporting their share of income from the partnership in their own tax returns. The allocation of income and losses between the partners is done through agreement, either in the form of a formal written partnership agreement, or as decided amongst the partners. In addition, the tax characterization of the income retains its character, so that a capital gain in the hands of the partnership is still a capital gain in the hands of the partner to whom it, or a portion thereof, is allocated.²⁰

Although the partners do not actually own the property of the partnership directly, the partnership itself cannot own property. Instead it has been suggested that partners hold the property as property of the partnership, which really means property of the partners to be used in their common business. This is reflected in various provisions of the *Act* where taxpayers are deemed to hold the property of a partnership directly.

The *Act* contains a number of specific rules which will deem a partnership to be a person for specified purposes. These include the application of certain anti-avoidance rules such as the debt forgiveness rules, Part IV.1 tax, affiliated person rules (and associated anti-avoidance rules) and withholding requirements on payments to non-residents. Partnerships are also deemed to be

¹⁴ For a more detailed discussion of the tax treatment of LLPs see Bill Maclagan and Kevin P. Zimka, "New Business Vehicles: British Columbia Limited Liability Partnerships and Alberta Unlimited Liability Corporations," 2005 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2005), 6:1-29.

¹⁵ *Partnership Act*, *supra*, section 96.

¹⁶ *Ibid.*, section 97.

¹⁷ See for example Manitoba's *The Partnership Act*, C.C.S.M. c. P30, paragraph 69(1)(a).

¹⁸ P. Lailey, *infra*, footnote 25.

¹⁹ See Regulation 229.

²⁰ Paragraph 96(1)(c).

persons for the purposes of certain tax incentives including the flow through share rules and scientific research tax credit rules.

In some instances there is some doubt as to whether specific provisions of the *Act* which do not deem a partnership to be a person can be applied to partnerships on the basis of the general rules relating to partnerships.

One example is whether subsection 15(2) will apply to a loan made by a corporation to a partnership where the majority interest partner is also a shareholder of the lending corporation. Subsection 15(2) specifically applies to partnerships which are connected to a shareholder. However, the rule for determining whether a person is connected to a shareholder in subsection 15(2.1) does not deem a partnership to be a person.

In *Gillette vs MNR*²¹, the Tax Court of Canada held that the application of subsection 15(2.1) to a partnership could not be inferred by subsection 15(2) or section 96:

“Since subsection 15(2) clearly distinguishes between a person and a partnership and subsection 15(2.1) defines when a person is connected for the purposes of subsection 15(2), it follows that subsection 96(1) cannot be relied on to deem a partnership to be a person for the purposes of either subsection 15(2) or 15(2.1). Therefore, subsection 15(2.1) does not apply to a partnership since the provision only refers to a person.”²²

The Federal Court of Appeal upheld the decision of the Tax Court of Canada but on different grounds without having to confirm or dispute whether or not subsection 15(2.1) could apply to a partnership. As of the date of the writing of this paper the CRA²³ continues to take the position that 15(2.1) applies to partnerships and would likely asses on this basis.

These unique tax attributes, and the commercial advantages make partnerships an attractive vehicle for carrying on business. However, these advantages are also offset by disadvantages and potential traps that have to be reviewed before deciding to form a partnership as a business vehicle.

For a more detailed discussion of the taxation of professional partnerships, including the taxation of partners on the disposition of their partnership interest, see Paul Lailey’s article *Tax Issues on Entering and Leaving a Professional Partnership*.²⁴

D. SELECTED ADVANTAGES OF CARRYING ON BUSINESS THROUGH A PARTNERSHIP

Some of the tax advantages of using a partnership include:

1. Elimination of entity level taxation;

²¹ [2001] 4 CTC 2884, affirmed in [2003] 3 CTC 27 FCA.

²² *Gillette* at paragraph 52.

²³ See Technical Interpretation 2004-0067261E5.

²⁴ 2005 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2005), 10:1-10:16.

2. Potential for tax deferral;
3. Ability to allocate income selectively; and
4. Ability to carry out tax deferred reorganizations.

1. Elimination of Entity Level Taxation

Participants entering a business have the choice of several business organizations. Potential business organizations include: a sole proprietorship, a partnership (in its various forms), a trust, a joint venture or a corporation. Each of these organizations will have a variety of features that warrant special consideration from a business perspective as well as a tax perspective.

The use of a corporate entity to own a business limits the liability of the participant by interposing a separate legal entity between the investor and the business. However, a corporation is also a separate taxpayer and the interposition of a corporation usually comes at the cost of additional taxation and a deferred deduction for amounts invested in the business.

Despite the stated policy of integration, the combined amount of corporate and personal income tax imposed on income earned by a corporately held business and distributed in the year to a shareholder as a dividend will generally be higher than the total amount of income tax which would be payable if the income from the business were taxed directly in the shareholder's hands.

Recently proposed amendments²⁵ to reduce personal income tax on certain dividends will reduce the tax differential. However, unless parallel provincial legislation is also enacted and until the federal legislation is implemented and fully phased in, there will remain a tax disincentive to having an incorporated business in a number of circumstances.²⁶ Moreover, certain persons, including non-residents and non-taxable entities may better served by eliminating the second level of taxation rather than looking to the proposed changes in the dividend tax credit for relief.

A joint venture also provides for a full flow-through of income and losses to participants. However, joint ventures do not provide any liability shield. Moreover, a joint venture may not be an appropriate vehicle for an ongoing business. Furthermore, the special rules in the *Act* which treat a partnership as a person for certain purposes cannot be relied upon by the participants in a joint venture.

A trust also allows for the flow-through of certain types of income to its beneficiaries. However, there are a number of disadvantages to using a trust as a business vehicle. These include the potential unlimited liability of the beneficiaries, the inability to flow out losses and deductions to beneficiaries, the requirement that trust income be paid or made payable in order to avoid taxation in the trust and the twenty-one year deemed disposition rule.²⁷

²⁵ Legislative Proposals and Explanatory Notes Relating to Income Tax Dividend Taxation Published by Minister of Finance June 2006.

²⁶ The amount of tax differential will depend on the particular circumstances of the business and the shareholders.

²⁷ See subsection 104(4).

The tax savings provided by the elimination of entity level taxation is the principal rationale behind the phenomenal rise in income trusts as the preferred vehicle for publicly owned and traded businesses. The income trust itself is used as a vehicle to aggregate investors and provide liquidity but never to own and operate the business because of the disadvantages described above and the limits on the undertakings that a mutual fund trust can engage in. Instead the business is owned and operated by a corporation or an LP. With an LP there is full flow through of all income to the income trust as a distribution to the limited partner. The business itself is managed by a corporate general partner which is fully liable for the obligations of the business. Partnerships are not subject to large corporations tax and therefore a partnership structure can eliminate large corporations tax.

Large corporations tax is generally not a concern for small businesses. However, where the taxable capital of a corporation exceeds certain thresholds, such corporation will not be able to access the small business deduction and other tax incentives such as enhanced SR & ED credits. If the business is held by a partnership with corporate and non-corporate partners, such tax incentives may still be available.²⁸

If a new business will incur start up losses, the use of a partnership to carry out such business will allow the partners to offset their initial investment in the partnership business against income from other sources. This can be contrasted with starting up a business in a corporation where start up losses are only deductible against future income of the corporation. In a corporate start up, the initial investment in the business will be debt and/or share equity to the investor. Tax recognition of a share investment will generally only be available in the form of reduced tax on the sale of the shares. If the share or debt of a corporately held business is disposed of at a loss, the shareholder in a corporately held business can only claim an income loss where the requirements for claiming an allowable business investment loss (“ABIL”) are met.²⁹ These requirements do not apply to losses realized with respect to an investment in a partnership

2. Potential for Tax Deferral

Allocations of net partnership income or losses to the partners are made automatically at the end of the partnership’s fiscal year. These allocations are then accounted for in the partner’s taxable income as of the date of that allocation. A partnership may choose any date for its fiscal year end. However, where a partnership has as a partner who is an individual (other than a testamentary trust) or a professional corporation, the taxation year end for the partnership must be December 31.³⁰ The taxation year of the partnership (for the purposes of calculating and allocating tax consequences of the partnership) is the fiscal year end of the partnership.³¹

Where the partnership’s fiscal year differs from the taxation year of a partner, there may be a deferral of the obligation to pay tax on partnership income. For example, a partnership can be structured to have a fiscal year end which occurs just after the fiscal year end of one or more of its partners. The income from the partnership for the previous 12 months will come in to the

²⁸ See Cherniawsky, *supra* at 14:13.

²⁹ See subsection 39(1)(c).

³⁰ See section 249.1.

³¹ Subsection 96(1)(b).

income of the partner early in that partner's year creating a permanent deferral. Although the CRA has suggested that this structure is a misuse and abuse of the *Act* for the purpose of section 245, the Tax Court of Canada has found that a single year deferral structure does not offend the provisions of the *Act*.³² Indeed, the Court went as far as to say that, where there is a legitimate business purpose, it is possible to stack several partnerships and defer the tax owing several times.

A deferral is often built into transactions under which corporately held businesses are transferred into a partnership having one or more corporate partners. Such partnership will not be subject to the requirement of having a calendar year end. Such transfers are sometimes structured to leave deductible expenses in the corporation for the year ending before the first year that partnership income is received. This planning results in significant tax losses to the corporation and additional deferred income to the partnership. Such losses may be carried back to offset income from previous years. In considering this structure, planners should be aware that this planning may prove to be a significant impediment to future reorganizations or acquisitions of the business by flow through consolidators such as income trusts and private equity funds. This is because income trusts must have calendar year ends and private equity funds often have calendar year ends as well. On an acquisition, all of the income which was deferred by converting a corporately held business into a partnership will be realized on an acquisition of the business by the income trust.

3. Ability to Allocate Income Selectively

Since a partnership is not a taxable entity, the income of the partnership is passed on to the partners of the partnership. The exact allocation of the income is to be determined by the partners, and is usually done through the partnership agreement. As a contract amongst the partners, the allocation is limited only by the agreement of the partners. This makes it possible to allocate sources of income to partners depending on their different contributions to the partnership as well as their status.

The principle income tax constraint on the ability to allocate income amongst partners from an income tax perspective is section 103. Where the conditions for triggering this section are met, the CRA can reallocate income amongst partners. Section 103 contains two alternate rules. Subsection 103(1) applies to partners who deal with each other at arm's length and subsection 103(1.1) relates to partners who do not deal with each other at arm's length. The text of section 103 is as follows:

(1) Where the members of a partnership have agreed to share, in a specified proportion, any income or loss of the partnership from any source or from sources in a particular place, as the case may be, or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of any of the members thereof, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under this Act, the share of each member of the partnership in the income or loss, as the case may be, or in that other amount, is the amount that is reasonable having regard to all the circumstances including the proportions in which the

³² *Fredette*, 2001 DTC 621 (TCC).

members have agreed to share profits and losses of the partnership from other sources or from sources in other places.

(1.1) Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.

Pursuant to section 103 allocations of income and losses which are reasonable in the circumstances cannot be disregarded by the CRA whether the partners deal with each other at arm's length or not. If the parties deal with each other at arm's length, it is also necessary that it be demonstrated that the principal reason for the agreement relating to the allocation of income or loss may reasonably be considered to be the reduction or postponement of tax that might otherwise have been payable.

There are few reported cases on section 103. There are a number of technical interpretations in which the Canada Revenue Agency provides some guidance as to which types of allocations it would consider reasonable or not.

In *XCO Investments*³³ the court held that the arrangement between arms' length partners fell "squarely within [subsection 103(1)]". In that case an existing partnership was expanded to include Woodward's Stores Limited, an entity with significant tax losses. Woodward's had signed and delivered a notice of withdrawal to the partnership one week after it joined. During that time the partnership sold a single property, which it had owned prior to Woodward's admission, and allocated most of the income from that sale to Woodward's, while paying only a fraction of that amount to Woodward's. The amount paid to Woodward's was roughly 1/10th of the amount Woodward's actually earned on the transaction. Bowman C.J.T.C.C. found that:

The principal reason for the partnership's division of profits is the reduction of tax and the share of profits, given Woodward's temporary and risk free involvement in the partnership, is inherently unreasonable.³⁴

The allocation of income to Woodward's was thus reduced to the actual amount of income earned by Woodward's in the transaction, and the Appellant's income was increased by a corresponding amount. It is very likely that, had the actual amount paid been similar to the amount allocated, Chief Justice Bowman would have found that the allocation was not unreasonable and left the amount unaltered. In particular, the following comments regarding reasonableness should be kept in mind:

The first is that while "reasonable" is a relative term and what is reasonable must depend on all of the circumstances, its determination is clearly not a discretionary

³³ *XCO Investments Ltd. v. R.*, 2005 DTC 1731 (T.C.C.).

³⁴ *Ibid.*, para. 34.

act on the part of the Minister. It would be wholly unacceptable if in reviewing the Minister's decision on what is "reasonable" the court were fettered by the theory that the Minister's decision was a discretionary one and the rules about reviewing a discretionary act and showing deference to the Minister's decision had to be observed. However far reaching section 245 may be, it does not confer discretionary powers on the Minister, either in the decision to apply it or in the determination of its consequences.³⁵

It would appear that the Chief Justice's comments regarding reasonableness were equally applicable to its use in section 103 as it was to section 245. Thus, the allocation may be reasonable in the circumstance even if it does not perfectly match the economic realities of the transaction.

Subject to section 103, members of a partnership can draft the agreement so that income is allocated to them and cash is paid out to them based on a number of considerations including the agreed upon value of each member's contribution, entitlement, personal tax considerations and other issues. This can be contrasted with the position of a shareholder in a corporation who has ownership of a share which carries certain rights by law. Absent the drafting of special provisions, the entitlements attached to shares are not linked to contributions by shareholders. If a shareholder ceases to make the agreed upon contributions to the business, the other shareholders cannot easily change the economic entitlements attached to the shares and the shareholder avails itself of the statutory remedies provided under corporate law.

4. Ability to Carry Out Tax Deferred Reorganizations

The *Act* allows persons to transfer property into a partnership on a tax deferred basis and to transfer property out of a partnership to its members in certain circumstances on a tax deferred basis. The ability to transfer property into and out of a partnership allows for a business to be moved into a partnership or to be transferred out of a partnership into another entity such as a proprietorship or a corporation on a tax deferred basis. The ability to roll property in and out of a joint venture is not available to members of a joint venture. In a joint venture each co-venturer member must retain ownership of its own property and any transfer of ownership is a taxable event to the co-venturer.

There are two basic planning methods for transferring a partnership business into a corporation. These are as follows:

- (a) **Roll Asset.** The partnership will transfer its assets to a newly incorporated corporation in exchange for shares of the corporation under subsection 85(2). The partnership will be wound up within 60 days pursuant to subsection 85(3). This will result in each partner acquiring shares of the corporation that owns the business in proportion to their interests in the partnership on a tax deferred basis; or

³⁵ *Ibid.*, para. 39.

- (b) **Roll Partnership Interest.** Each partner can transfer his or her interest to the corporation on a tax-deferred basis pursuant to subsection 85(1) in exchange for shares of the corporation. The partnership will cease to exist once the corporation owns all of the interests in the partnership and subsection 98(5) will apply so that all the partnership property will be considered to have been transferred on a tax-deferred basis to the corporation. The tax deferral on a subsection 98(5) is only available where one of the partners of an existing partnership continues to carry on the business. This condition will not be met if both the original partners transfer their interests to the corporation at the exact same time because this will terminate the partnership. Therefore if the reorganization is to be carried out under subsections 85(1) and 98(5), it is important to structure the transfer of the interests in the partnership to the corporation as two separate transactions so that following the first transfer the partnership will continue to exist as a partnership between the partner who has not yet transferred his or her interest and the corporation.

There are other methods of converting the partnership into a corporation and the optimal method will depend on the particular circumstances of the partners.³⁶ One of the key conditions for accessing the rollover provisions is that the partnership must be a Canadian partnership which is essentially a partnership in which all of the partners are resident in Canada.³⁷

Once the business has been transferred into a corporation, income from the business will be eligible for the small business deduction. Furthermore, the partners may be able to sell all or part of their interests in the business by way of share sale in a manner which is eligible for the \$500,000 lifetime capital gains exemption.

The \$500,000 lifetime capital gains exemption is one of the most important tax incentives for owner manager businesses. Although, this incentive is only available on the sale of qualified small business corporation shares,³⁸ the *Act* contains special rules which facilitate the claiming of the capital gains exemption on shares of a corporation which acquired a qualifying business from the partnership. For example, treasury shares issued to a partner in consideration for his or her interest in the partnership, or in connection with the transfer of all or substantially all of the assets used by the partnership in a business to the corporation, will not be deemed to have been held by an unrelated person prior to the time of issuance.³⁹

Therefore, a partner who has become a shareholder of a newly incorporated small business corporation on the transfer of the partnership business to the corporation, may claim the capital gains exemption even though the corporation has been in existence for less than 24 months. This rule also applies to shares of a corporation held by a partnership. Accordingly, individual partners may claim the capital gains exemption on their proportionate share of the proceeds realized by the sale by the partnership of qualified small business corporation shares. This is made possible through the deeming rule in paragraph 110.6(14)(d) which deems a partnership to be related to a

³⁶ For a more detailed discussion on reorganizing partnerships into corporations, see *Wind-ups and Mergers of Partnerships* 2005 O.C. Fabiano, N.

³⁷ See section 248(1) and 102(1).

³⁸ See subsection 110.6(2.1).

³⁹ See paragraph 110.6(14)(f).

person for any period throughout which the person was a member of the partnership. Furthermore, proposed paragraph 110.6(14)(d.1) will deem a person who was a member of a partnership that is a member of another partnership to be a member of the first mentioned partnership so that the capital gains exemption can be claimed where an individual is a member of a partnership which is a member of the partnership which sells the qualified small business corporation.⁴⁰

Under section 85, real property used as inventory (“RPI”) cannot be rolled into a corporation on a tax-free basis.⁴¹ RPI can however be rolled into a partnership under subsection 97(2). In addition, since a partnership interest is a capital property, it is thus an eligible property that can be rolled into a corporation.⁴² This makes it possible to transfer RPI from a taxpayer to a corporation on a tax deferred basis by first transferring the property to a partnership pursuant to subsection 97(2) and to then transferring the partnership interests into a corporation under section 85.

In *Loyens*⁴³ this two-step rollover was used to transfer RPI from individuals to a partnership and on to a company with loss carry forwards owned by the partners. The company subsequently sold the property to third parties and used the company’s losses to shelter the income realized on the sale of the property. The proceeds were reported as income and not capital gains.

This planning was challenged by the Minister as an abusive avoidance transaction pursuant to the general anti-avoidance rule (“GAAR”) in section 245. The Minister argued that the transactions were a “misuse” of subsection 97(2) to circumvent the 85(1.1)(f) prohibition against transferring RPI to a corporation on a tax deferred basis.

Justice Campbell found that the transaction was an avoidance transaction but that it was not a misuse of 97(2) because there was no unambiguous policy prohibiting transfers of land inventory on a tax deferred basis:

“...The most telling tale is this: If the policy was so clear, the same prohibition could very easily have been included in subsection 97(2). That was not done.

Has the above policy been violated? The policy behind paragraph 85(1.1)(f) is to prevent a real property trader from converting income into capital gains. Do the facts suggest that the Appellants violated this policy? No, they do not. All moneys related to the Harrison property were reported as income at every stage. There is no misuse of the provisions because the policy of converting income to capital gains is not violated.⁴⁴

⁴⁰ See proposed paragraph 110.6(14)(d.1).

⁴¹ See paragraph 85(1)(c.1).

⁴² See subsection 85(1.1).

⁴³ *Loyens v. R.*, 2003 D.T.C. 355 (T.C.C.).

⁴⁴ *Ibid.*, para 104, 105.

Justice Campbell found that there was no abuse having regard to the provisions of the *Act* read as a whole because “the general rule against loss trading has no equivalent rule when it comes to profit trading.”⁴⁵ In particular:

The Appellants struck a deal with a long-standing business partner. The first place they contacted was their tax advisor's office. He used the provisions of the *Act* in conjunction with a pre-existing partnership and corporations to structure the Appellants' agreement with Drewlo in the most tax efficient manner. The transactions were in accordance with normal business practice and were entered into for bona fide purposes (part of Fording approval applied in Novopharm). This does not amount to a misuse or abuse of the provisions of the *Act*. It is simply utilizing them for the very purpose for which they were designed.⁴⁶

Given the facts of *Loyens*, the two step rollover which is not part of the same series of transactions that includes a sale to a third party or which converts income into capital gains would likely not constitute an avoidance transaction which could be reviewed under GAAR.

E. SELECTED DISADVANTAGES OF CARRYING ON BUSINESS THROUGH A PARTNERSHIP

There are also disadvantages to carrying on business through a partnership. These include the requirement that partners must be carrying on a business (as opposed to passively investing); the limitations on control exercisable by limited partners; the “at-risk” limitation on deductions available to limited partners, statutory provisions which prevent a partnership from having a negative ACB, and the inability to claim the Small Business deduction directly on partnership income.

1. Must be Carrying on a Business

As a caution to persons contemplating forming a partnership for its tax characteristics, it must be remembered that a partnership is a relationship. Without the three fundamental building blocks of this relationship, a partnership does not exist. Traditionally it has been thought that the criteria that a partnership must be carrying on an active business was a low threshold, but recent cases from the Tax Court of Canada demonstrate that these fundamental characteristics are often examined by the Court. Several taxpayers have lost their appeal because they were found not to be in a partnership.⁴⁷

⁴⁵ *Ibid.*, para. 114.

⁴⁶ *Ibid.*, para. 118.

⁴⁷ See for example, *Whealy v. R.*, [2005] 3 C.T.C. 2099; (2004), 58 D.T.C. 2888 (TCC) aff'd 2005 3 CTC 92 (FCA), *Geddes Contracting Co. v. R.*, [2005] 1 CTC 2717 (TCC) aff'd by [2006] 2 CTC 241 (FCA), and *Eidsvik v. R.*, 2006 DTC 2856.

2. Amount “At Risk”

Although general partners and partners of a partial shield limited liability partnership can deduct all losses that are allocated to them as partners, limited partners, as defined in the *Act*,⁴⁸ can only deduct losses up to their “at-risk” amount.⁴⁹

The “at-risk” amount is defined in subsection 96(2.2) and is essentially the adjusted cost base (“ACB”) of the limited partner’s interest in the partnership (adjusted for allocations of income and losses) less the total of all amounts which reduce the real economic risk to the limited partner. These amounts include any benefits which the limited partner or persons who do not deal at arm’s length with the limited partner are entitled to immediately or in the future, absolutely or contingently, including any rights to reimbursement, compensation, revenue guaranties or any other rights. A benefit is essentially any right which is granted to reduce the impact of any loss a limited partner may sustain as a member of the partnership. The “at risk” amount is also reduced by any indebtedness incurred to acquire the interest in the partnership for which recourse is limited.⁵⁰ Therefore, if limited partners of an LP borrow to acquire their partnership, and partners of a full shield limited liability partnership borrow to acquire their interest in the LP on a limited recourse basis, the interest on the borrowing will not be deductible against other income. Losses in excess of the at-risk amount will be limited partnership losses and can only be deducted against income from the partnership.

3. Limited Control

With partnerships, the ability to have both limited liability and control over the business is not without complication. Limited partners may want to have some role in the management and control of the business. They may exercise this control indirectly through their ownership of shares of the corporate general partner or by serving as director or officer of the corporate general partner.

According to section 64 of the *Partnership Act* “a limited partner is not liable as a general partner unless he or she takes part in the management of the business”. This can be contrasted with legislation in other provinces which only triggers liability where the limited partner exercises control over the partnership.

In *Stillwater Forest Inc. v. Clearwater Forest Products Limited Partnership*⁵¹, the court dealt with the issue of whether the president of one of the limited partners, who was also chair of the board of directors for the corporate general partner, controlled the limited partnership. The Court found that the holding of positions as officer and director did not amount to the limited partner

⁴⁸ See subsection 96(2.4) for the definition of “limited partner”.

⁴⁹ Subsection 96(2.1).

⁵⁰ See paragraph 96(2.2)(c). If the interest in the partnership is a “tax shelter investment” the debt will be deemed to be a limited recourse amount unless the additional conditions in 143.2(7) are met.

⁵¹ (2001), 102 A.C.W.S. (3d) 221 (Sask Q.B.) this case dealt with Part 2 of the Saskatchewan *Partnership Act* R.R.S. 1978, c. P-3, s. 64 which uses the language of the B.C. *Partnership Act* but substitutes the word “control” for “management”.

controlling the limited partnership, primarily because individuals holding these positions could not proceed without an authorizing resolution from the board of directors.

Therefore, the general partner was governed by its board of directors as a whole and not by the limited partner. Furthermore, the limited partner alleged to have control of the limited partnership satisfied Pritchard J. that all decisions but one, the action of financing the limited partnership, were made in the limited partner's capacity as a director and not as a limited partner.

The Court also held that a limited partners providing financing to the limited partnership did not lose the protection of limited liability because approval of the financing was needed by the board of the corporate general partner. However, it may be significant in this case that the nominees of the limited partner providing the financing did not out vote the nominees of the other limited partners on the board. Therefore, the Court found that the real control for financing rested with those who controlled the majority of the board of directors.

In *Haughton Graphic Ltd. v. Zivot*⁵² the limited partners organized a limited partnership and incorporated a corporation to act as the general partner under the Alberta *Partnership Act*, R.S.A. 1980, c. P-2, s. 63 [now s. 64]. The principals, officers and directors of the general partner were two of the limited partners. The Court held that the limited partners were liable for the obligations of the limited partnership since the evidence illustrated that the members of the limited partnership participated in the management of the general partner via holding positions of authority on the board of directors and thus controlled the limited partnership.

The B.C. Court of Appeal in *Nordile Holdings Ltd. v. Breckenridge*⁵³ came to the opposite conclusion on similar facts. In that case, the plaintiff sold to the limited partnership a revenue property, and took up a substantial second mortgage. The plaintiff and the limited partnership were subsequently foreclosed out of their interest in the property by the first mortgagee. After the sole general partner became insolvent, the plaintiff's only recourse was to try and recover the debt from the defendant limited partners. The limited partners of the limited partnership were the directors and officers of the corporate general partner. The Court did not find the limited partners participating in the management of the limited partnership liable since their management participation was limited to acting as directors and officers of the general partner and not as a limited partner. However, what is significant in this case is that through an agreed statement of facts, it was agreed that the limited partners only acted in their capacity as directors when serving on the board of the corporate general partner.

The Canadian case law dealing with the extent to which participation by a limited partner on the board of directors of a corporate general partner will lead to a finding of liability as general partners is inconclusive. Therefore, limited partners who wish to hold positions as directors of the corporate general partner should approach the situation with caution and ensure that they are acting as directors of the corporate general partner and not in their role as members of the LP

Some provincial statutes, notably *The Partnership Act (Manitoba)*, allow for limited partners to take part in the management of the LP to a certain extent. For example, a limited partner in a

⁵² (1986), 33 B.L.R. 125 (Ont. H.C.J.) [*Haughton*].

⁵³ [1992] B.C.J. No. 322, 66 B.C.L.R. (2d) 183 (C.A.) [*Nordile*].

Manitoba LP may advise the general partners as to the management of the partnership, although it cannot bind the partnership without becoming a general partner.⁵⁴ However, it is not clear whether the law of the jurisdiction governing the limited partnership can be relied on to determine the liability of a limited partner for operations of the partnership in a different jurisdiction.

4. No Negative Capital

A partner's ACB of the partnership interest is increased and decreased by the allocation of income to that partner and the withdrawal of funds from the partnership by that partner respectively. The specific additions and deductions to the partners ACB are outlined in paragraphs 53(1)(e) and 53(2)(c). In general, losses allocated to a partner will reduce that partner's ACB whereas income allocated to a partner will increase that partner's ACB.

The timing of the adjustments to the ACB are not perfectly matched and this can lead to a capital gain in the hands of the partner. A draw by a partner from the partnership will reduce the ACB of the partner's partnership interest.⁵⁵ Although the income earned by the partner is added to the ACB of the partnership interest, this does not occur until the first day of the new fiscal year. Thus, at the end of a partnership's fiscal year, it is possible that the ACB will be negative due to the subtraction of draws, and the fact that additions from allocated income are not recognized until the beginning of the next fiscal year. A general partner can have a negative ACB, but where a limited partner or a partner in a full shield LLP has a negative ACB in respect of its partnership interest at the end of the year, a capital gain is triggered equal to the amount that is negative.⁵⁶

If the partnership is a full shield LLP such as a BC LLP, the partners will be taxable if their ACB goes negative in any taxation year. However, the proposed amendment to the *Act* described set in comfort letter from the Department of Finance⁵⁷ will enable partners of an LLP to adjust the ACB of their interest in the LLP at the end of the fiscal year to reflect income and loss allocations made by the LLP for that year.

Partnerships in British Columbia, including professional partnerships which are considering converting from general partnerships into LLP's should review the tax consequences including the application of the "at-risk" rules and the taxation of negative ACB.⁵⁸

5. No Direct Small Business Deduction And Other Corporate Based Incentives

The small business deduction ("SBD") is a reduced rate of income tax on active business income earned by a Canadian-controlled private corporation.⁵⁹ The combined federal and provincial tax rate on income which is eligible for the SBD for a corporation taxable in British Columbia is

⁵⁴ *The Partnership Act* (Manitoba), *supra*, section 62.

⁵⁵ Subparagraph 53(2)(c)(v).

⁵⁶ Subsection 40(3.1).

⁵⁷ See letter from Len Farber dated July 11, 2003.

⁵⁸ For a more detailed discussion on this issue see 2005 BCC British Columbia LLP's in Alberta ULC (Maclagen, B. and K. Zimka).

⁵⁹ See subsection 125(1).

17.6%. This is almost half of the combined federal provincial rate imposed on active business income.

Active business income of a partnership is not eligible for the SBD. Instead, such income is taxed in the hands of the partners at their applicable tax rates. If a partner is an individual, such partner will be taxed at the applicable marginal rate. A corporation which is a CCPC and is a member of a partnership and which qualifies as a CCPC, may claim the SBD on its share of net active business income from the partnership.

Active business income allocated by a partnership to a member which is a CCPC is specified partnership income within the meaning of subsection 125(7). The specified partnership income rules essentially limit the ability of a corporate partner to claim the SBD on partnership income to an amount equal to the aggregate of corporation's eligible share of income from all partnerships from active businesses carried on in Canada less any losses of the corporation for the year from active businesses carried on in Canada. Pursuant to the specified partnership income rules each partnership has one business limit, therefore the maximum amount of partnership income on which the corporate partner can claim the SBD will be equal to its proportionate share of all income from the partnership.

Each member of the partnership is considered to be employing the full number of employees employed by the partnership in the business. Therefore, as long as the partnership itself is employing at least six full time employees, each corporate partner will not be considered to be carrying on a specified investment business even if the partnership is earning income from property.⁶⁰

In certain professional partnership structures, a two tiered professional corporation is used as a means of avoiding the application of the specified partnership income rules. In such structures the corporate partner is owned by a management corporation which renders services to the corporate partner. According to some recent rulings, the income from such services may eligible for the small business deduction.⁶¹

Another disadvantage of using a partnership is the uncertainty as to whether or not an estate freeze can be implemented. A founder of a corporately held business can freeze his or her interest by converting common shares into preferred shares. The ability to effect an estate freeze of a business held by a partnership is questionable because of the potential application of section 103.⁶²

⁶⁰ See answer to question 51 at the 1988 Canadian Tax Foundation Annual Conference Round Table in which the CRA stated that for the purpose of the definition of specified investment business "With respect to the partners income from the particular partnership only, each full time employee of the particular partnership will be considered to be a full time employee of each corporate partner, whether general or limited." As confirmed in subsequent CRA interpretations including Technical Interpretation 2000-0047815.

⁶¹ For a more detailed discussion of a two tiered structure see *Professional Corporations* (Thompson, David) 2005 BCC.

⁶² See 1992 Canadian Tax Foundation Round Table response to question 13. In a recent interpretation the CRA indicated that there may be circumstance in which an estate freeze can be implemented in a partnership see technical interpretation 2004-0070001C6.

In addition to the SBD, there are other incentives in the *Act* which are only available to corporations. For example, the employee stock option rules in section 7 will not apply to an employee of a partnership because a partnership is not a qualifying person pursuant to subsection 7(8). Therefore, a corporation must be interposed in order to provide an equity based incentive to employees (see example below).

Another example of preferential treatment of corporations is for private health services plans (“PHSP”). Where a business is incorporated, the limits on benefits that can be provided under a PHSP are based on reasonableness and on there being no shareholder benefit being provided. However, if a partnership wishes to establish a PHSP, the maximum amount of benefits that can be provided will be subject to limits set out in section 20.01 of the *Act* which is the lesser of the cost of equivalent coverage or \$1,500 per adult and \$750 per child.

In summary, there are a number of advantages and disadvantages from an income tax perspective of using a partnership as a vehicle for a business. Ultimately, the particular circumstances of the business will determine whether or not a partnership is an appropriate vehicle and partners should verify the material tax considerations including any material tax incentives.

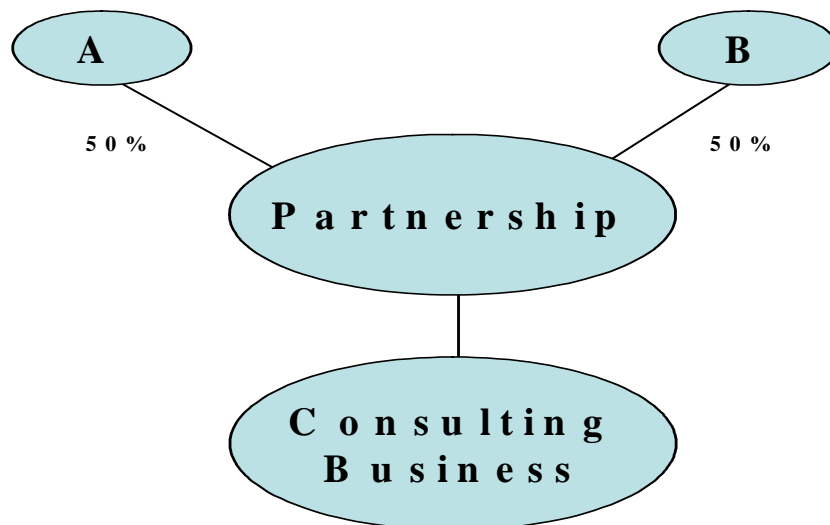
F. TAX PLANNING USING PARTNERSHIPS

The following section will provide examples of the partnerships being used as a structure for different situations. These examples will highlight some of the advantages and disadvantages of using partnerships from an income tax perspective.

1. Example 1 - Consultancy Business

(i) Organizational Diagram

F I G U R E 1



(ii) Fact Pattern

Two Canadian resident individuals who deal with each other at arm's length want to start up a consultancy business. The business will earn income primarily from services offered by the partners to the public. Each partner will contribute sufficient cash for start up costs and give personal guarantees to their lessor and banker.

(iii) Structuring Issues

The partners will structure the partnership as a general partnership or as an LLP because the liability risk does not justify the additional cost and complexity of establishing an LP.

The partnership agreement will set out the obligation of the partners are to devote their full time and effort to the business of the partnership and to contribute capital as needed. The agreement will also set out each partners' entitlements to partnership income, distributions of cash and returns of capital.

(iv) Tax Advantages

Net income will be calculated at the level of the partnership. Each partner will be allocated his or her proportionate share of all income, gains and losses from the partnership business at the end of each calendar year.

Income will be taxed in the hands of each partner at his or her marginal tax rate. If the partnership is a general partnership, each partner will be able to deduct his or her share of partnership losses against income from other sources without limitation and will not be taxable if the ACB of his or her interest goes negative in a year. A partner who borrows to finance partnership expenses will be entitled to deduct the interest on the borrowing on the full amount contributed.

If the partnership is a BC LLP, deductions of partnership losses against other income will be subject to the at risk limits. A partner will be taxable if his or her ACB goes negative in a year. However, assuming the proposed legislation is enacted, each partner will be able to adjust the ACB of his or her interest in the LLP at the end of each fiscal year to reflect income and loss allocations made by the LLP at that time. Any borrowings to finance the contribution to the partnership which are not full recourse amounts will reduce the partner's at risk amount.

The income from the partnership will not be eligible for the SBD. This will be a disadvantage to the extent that earnings from the business are retained and reinvested in the partnership. To the extent that all net income is being distributed out to the partners each year the inability to access the SBD will not result in any increased tax payable.

The partnership cannot pay salaries to the individual members⁶³ and therefore no deductions can be claimed with respect to services rendered by the partner to the partnership. This also means

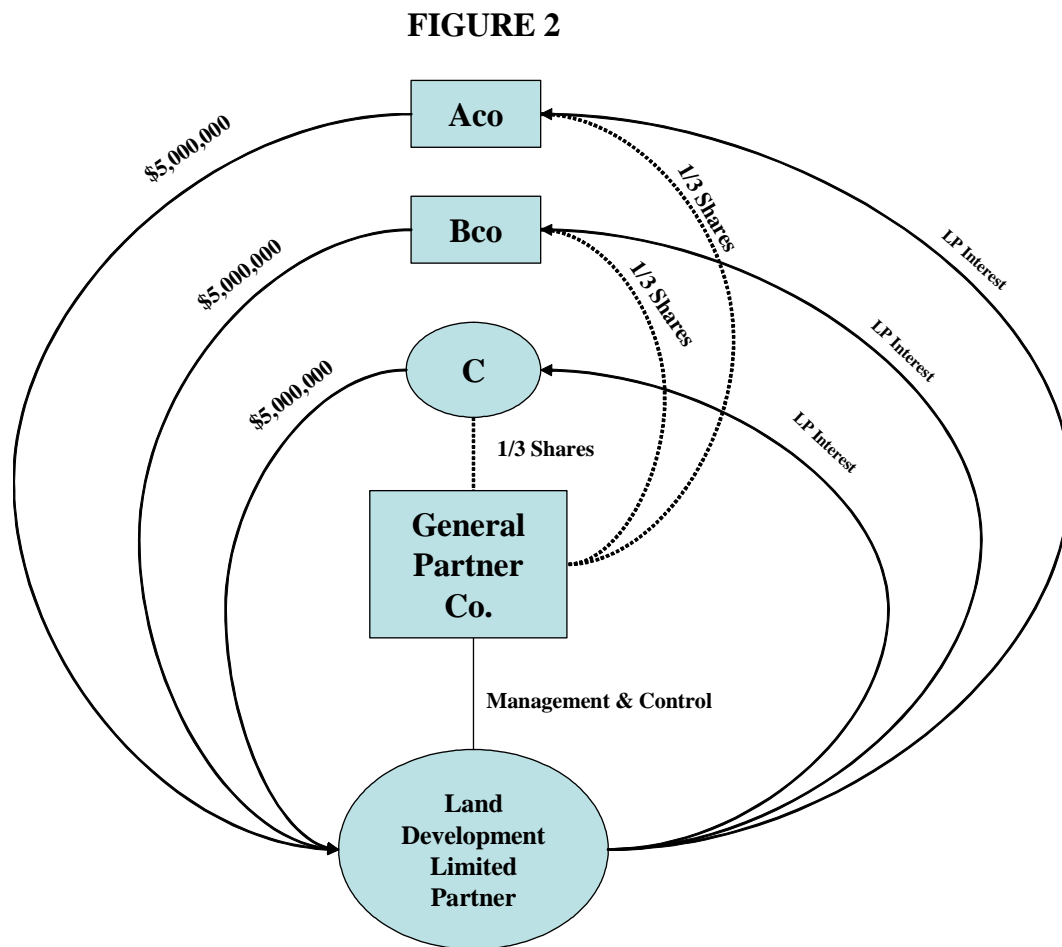
⁶³ See CRA Interpretation 2002-0132797

that the partners cannot claim losses for the amount of time spent by them in the partnership business.

The partners can convert the partnership into a corporately held business at a later date. The conversion can be implemented on a tax deferred basis by either of the methods mentioned above. The partners will be able to claim the SBD on income from the business when it is corporately held and may be eligible to claim the capital gains exemption on a sale of the business by way of sale of shares.

2. Example 2 - Land Development Partnership

(i) Organizational Diagram



(ii) Fact Pattern

Aco and Bco are CCPC's and C is a Canadian resident individual. All partners deal with each other at arm's length. The partners objectives are the construction and development of a hotel on a vacant lot. Income will be earned from the sale and marketing of hotel room strata units, management of the hotel and rental of commercial space.

Each partner has committed to contributing \$5,000,000 in capital. Aco's principals will focus on the business plan and marketing of hotel strata units. Bco's principals will focus on the acquisition of the land, and construction of the hotel. C will focus on the business plan for the management of the hotel.

(iii) Structuring Issues

The partnership will be structured as a limited partnership to ensure the maximum liability shield for all partners against any liabilities which may arise in connection with the development and construction of the property and the on going commercial activities of the partnership. Such protection cannot be provided to C by a joint venture.

General Partnerco will manage the operations of the partnership and all individuals will act solely in their capacity as representatives of the corporate general partner. One or more key employees may serve on the board of General Partnerco.

General Partnerco can acquire and hold registered title to the land as bare trustee for the partnership and can convey registered title of the strata units to the purchasers.

The partnership agreement will set out the business deal between the partners including allocations of income, distributions of cash, contributions and withdrawals of capital and other key terms. The agreement may provide that partnership income and losses will be allocated to the partners in proportion to their capital and that cash available for distribution will be paid out in the same manner. If income has to be re-invested, the agreement can provide for cash distributions which are sufficient to cover each partners' tax liability on all allocated but undistributed income. Such special distributions can be timed to match the filing due date for each partner.

The partners can also agree that all or some of each partner's share of income or entitlement to cash will be based on the measurable value of a particular partner's contribution to the business. For example, Bco could be entitled to a special allocation of income for completion of construction below budget or on or before the projected completion date. Similarly, Aco or C could also be entitled to a special distribution for exceeding earnings targets. Moreover, the provisions of the agreement relating to the allocation of income and distributions of cash could penalize a partner for below budget performance or for failing to make timely and sufficient contributions of capital. The agreement can also require that members be Canadian resident and provide for a forcible buy out in the event of a change in residency status.

(iv) Tax Advantages and Disadvantages

Net income and losses from the partnership will be allocated to each partner as of December 31 of each year. Each partner will be able to deduct his or its share of the initial \$5,000,000 investment spent on current expenses up to the amount of each partner's at risk amount.

If Aco or Bco have off-calendar year ends, they will be able to defer the inclusion of partnership income by up to 11 months.

The principal's of the corporate partners may use limited recourse debt indirectly to finance their contributions to the partnership by taking out loans at the shareholder level to enable the corporate partners to fund their contributions. Subject to the general rules on interest deductibility, the interest on such loans will be fully deductible against income of the shareholder. The investments may be funded as share capital in Aco and Bco to ensure that any losses realized on such loans may qualify as an ABIL.

Taxable capital employed in Canada will not be calculated at the level of the partnership. Instead, it will be calculated at the level of each corporate partner with such partner's interest in the partnership being included in its taxable capital. Therefore the individual partner will not be subject to any large corporations tax which would have been imposed if this were a corporately held business and the taxable capital employed in Canada exceeded the threshold for the imposition of large corporations tax.⁶⁴

The corporate partners can also claim an investment allowance with respect to the investment allowance that would be allowed by the partnership if it were a corporation for its investments in proportion to the partner's share in the partnership.⁶⁵

Aco and Bco will be able to claim SBD on their proportionate share of the income from the partnership. If a corporation had been used for this business the taxable capital employed in Canada would be over \$15 million and this would grind down the business limit and access to the SBD. Instead, only \$10,000,000 in capital will be allocated to the two corporate partners.

(v) Variation on Factual Situation: Partner C Contributes \$5,000,000 in Additional Cash

The partners determine that they will require at least \$5,000,000 in additional cash to cover start up costs which cannot be financed at reasonable rates. The only partner who has sufficient cash is partner C, and he agrees to make such additional contribution provided he is compensated in a tax effective manner.

If the partnership agreement allocates income and cash strictly according to capital. The additional contribution by partner C would result in partner C having contributed 50% of the capital and being entitled to 50% of the partnership income and losses. Partner C would now bear a greater risk of the failure of the business and a greater share of the profit if it succeeds. Since capital is returned pro rata to partnership interest, the return of the additional \$5,000,000 in capital contributed to partner C would be deferred until sufficient earnings were realized by the partnership.

If this arrangement is not satisfactory, the partners may use the partnership agreement to compensate partner C for the special contribution and or to accelerate the repayment of such contribution.

For example, the agreement could provide partner C with the right to a preferential right to income equal to an agreed upon return on the extra cash invested. Partner C could also be granted

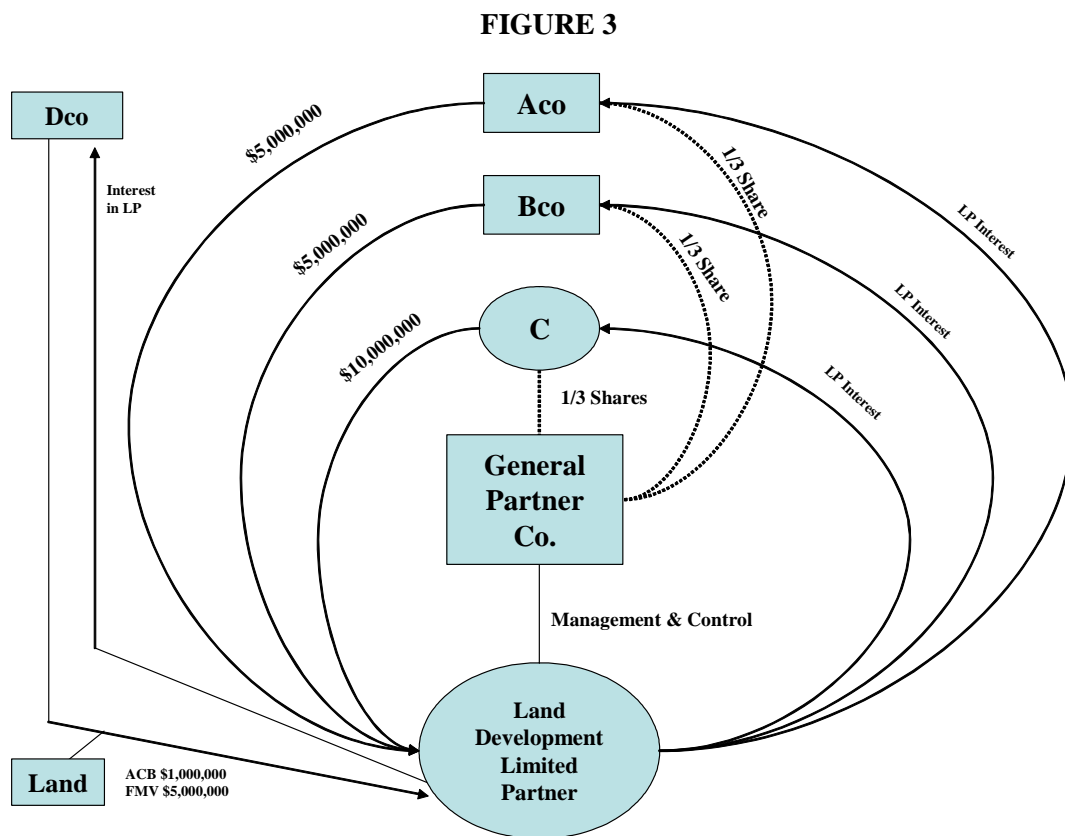
⁶⁴ See subsection 181.1(2)

⁶⁵ See proposed amendments to 181.2(5) and CRA document 2005-0131771E5

a preferential return of capital up to the additional \$5,000,000. Once the capital is returned or the special return on additional capital is paid out, income from the partnership could continue to be allocated and paid out in equal amounts to each partner.

These special allocations and rights can be provided through the issuance of a special partnership units or by amendment to the agreement. Since the partners deal at arm's length, this special allocation would likely be viewed as reasonable in light of the additional economic risk and cost to partner C. There is a lot of flexibility to tailor the entitlements to match the agreement between the parties.

(vi) Variation on Factual Situation: Rollover of Property



The owner of the land, Dco, indicates that it would be willing to exchange the land for an interest in the partnership rather than selling the land to the partnership. Since the property is being transferred to a partnership Dco can carry out the rollover despite any uncertainty as to whether the property is capital property or inventory to Dco

Dco will transfer the property to the partnership on a tax-deferred basis in exchange for units of the partnership. Dco and each member of the partnership will elect under subsection 97(2) to transfer the property at Dco's ACB. The partnership will acquire the property at a cost equal to

Dco's ACB. However, for the purposes of determining Dco's capital contribution, the fair market value of the land as agreed upon between the partners will be added to Dco's capital account.

The \$4,000,000 difference between the tax cost of the property and its fair market value will result in increased taxes on the sale strata units. If income is allocated solely on the value of capital contributed, this arrangement will result in an accelerated tax liability to the partners who contributed capital that had full basis.

This issue can be addressed by allocating the first \$4,000,000 in taxable income to Dco. All taxable income in excess of such amount would then be allocated to the partners in accordance with the agreed upon provisions of the partnership agreement.⁶⁶

The CRA has indicated in its administrative statements that this type of preferential allocation may be acceptable.⁶⁷ Note that the CRA has also indicated that in similar circumstances it would apply 103 if the method of equalization was to allocate losses to the full basis partners⁶⁸.

Distributions would still be made in accordance with the general formula set out in the partnership agreement so the preferential allocation of taxable income would not reduce the amount of cash distributed to the other partners. Such partners would treat their first \$4,000,000 worth of distributions as a return of capital.

(vii) Variation of Factual Situation: Earned Interest

Bco does not have sufficient cash to make the capital contribution and has instead asked that a portion of its interest in the partnership be issued in consideration for construction services to be rendered in connection with the project. The value of each interest in the partnership will increase over time as the property is rezoned and developed and therefore Bco would prefer to acquire its capital interest at the formation of the partnership so that it will realize its share of appreciation. The solution to this problem is to provide in the partnership agreement for an earned interest.

The earned interest can be structured as a loan which will be offset against construction costs. Bco will acquire a \$5,000,000 capital interest. However, the unpaid portion of the \$5,000,000 capital contribution will be a debt payable to the partnership with interest. As construction services are rendered by Bco to the partnership, the payment for such services is offset against the debt.

The advantage of this arrangement is that it equalizes the contributions on an after tax basis. There are some disadvantages of this arrangement to Bco. In particular, Bco will be taxable on income from the construction contract which is credited to the repayment of the partnership loan.

⁶⁶ See technical interpretation 951344.

⁶⁷ Interpretation Bulletin IT-338R2 archived, "Partnership Interests—Effects on Adjusted Cost Base Resulting from the Admission or Retirement of a Partner," July 10, 1995, paragraph 5; IT-231R2 document no. B-4406, June 7, 1983.

⁶⁸ See technical interpretation 951344.

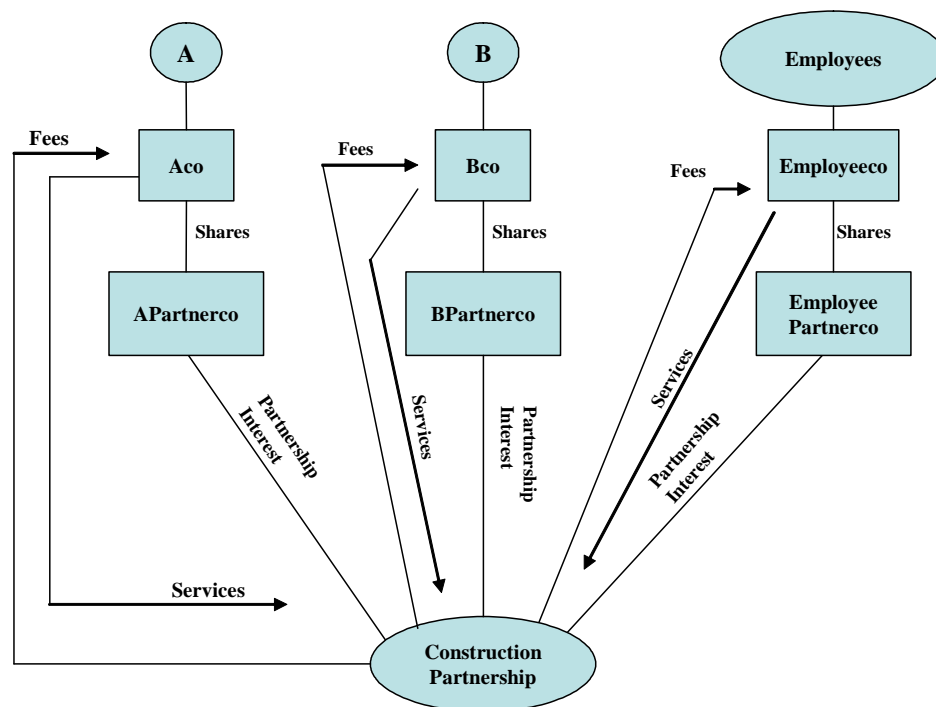
If Bco is taxable, it may not have sufficient funds to pay the income taxes on such income. This issue can be addressed by providing for a hold back on the construction contract which defers payment under the contract but not the crediting of the loan.

Bco can also be provided with a priority cash distribution sufficient to enable Bco to pay the tax liability arising out of the offset of payments under the construction contract against the capital loans.

3. Example 3 - Active Business Partnership that Provides Participation for Employees

(i) Organizational Diagram

FIGURE 4



(ii) Fact Pattern

The partnership has been carrying on business for a number of years and as a general contractor for large public infrastructure projects. The corporate status of the partners provides the liability shield. A and B have structured their affairs using a two tiered corporate partnership structure. Aco and Bco render services to the partnership and are compensated for such services. APartnerco and BPartnerco are partners of the partnership and earn income based on their distribution of profits after taking into account the deduction at the partnership level for all payments including those made on account of services.

(iii) Structuring Issues

A and B wish to provide a mechanism that will enable employees to participate in the growth of the partnership business in a tax efficient manner. A and B would like to provide for an employee stock option plan (“ESOP”) for certain employees and an employee share purchase plan for others (“SPP”). A and B would also like to consolidate the interest of the employees in a single entity which will have input into the management of the business.

A and B will establish a parallel two tiered corporate partner structure for the employees. Employeeco will be incorporated and organized to provide the services of the employees to the partnership for fees in a similar manner to Aco and Bco. Employeeco will incorporate and organize Employee Partnerco which will then subscribe for interests in the partnership. Employeeco will use the funds received from the subscriptions for shares in Employeeco by the employees. Employeeco will earn income from services rendered to the partnership and Employee Partnerco will receive distributions of partnership income.

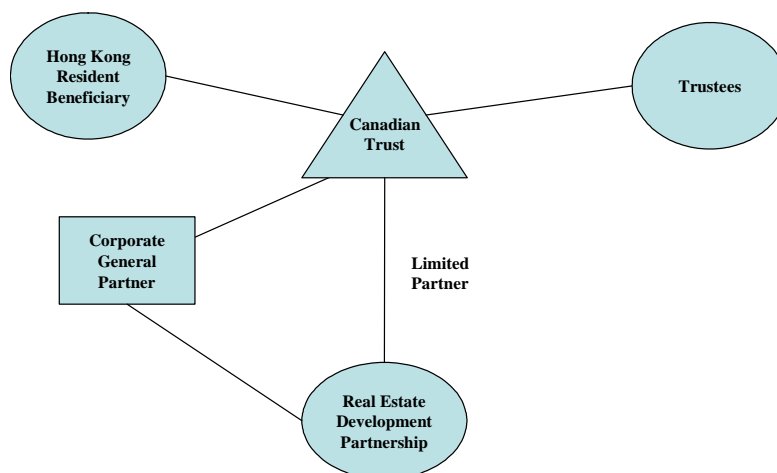
The employees will be able to subscribe for shares of Employeeco pursuant to the ESOP or SPP. Aco and Bco may also provide financing to Employeeco to enable it to loan to the employees sufficient funds to purchase their shares.

The transaction will be structured so that the shares of Employeeco are qualified small business corporation shares so that the employees could claim their capital gains exemptions on any sale of the business effected by way of sale of shares of Aco, Bco and Employeeco. The shares of Employeeco may also be qualified investments for registered retirement savings plan under subsection 4900(12) of the Regulations to the *Act*. This will enable those employees who wish to acquire their shares in their RRSPs to do so. Adequate salaries will be paid to the employees to ensure that the anti-avoidance rule in subsection 4900(13) does not apply.

4. Example 4 - Real Estate Development by Non-Treaty Non-Resident

(i) Organizational Diagram

FIGURE 5



(ii) Fact Pattern

A non-resident of Canada who is resident in a country with which Canada does not have an income tax convention wishes to purchase and develop property in Canada. A portion of the development will be commercial rental property and another portion will be a strata development.

(iii) Structuring Issues

The non-resident needs a legal structure for acquiring the property, financing the development, selling the strata units and continuing to carry on the rental business.

If a corporation is used, the combined amount of domestic corporate tax (approximately 34%) and non-resident withholding tax (25%) raises the total rate of Canadian income tax to approximately 51%.

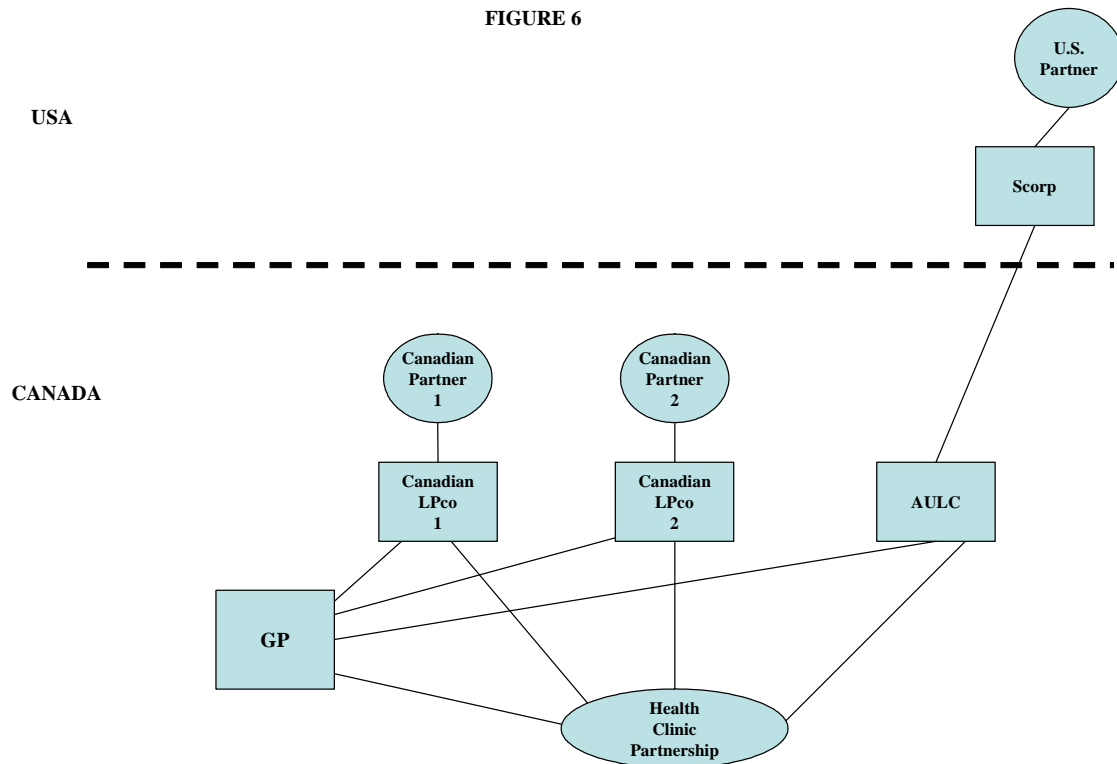
An LP will be created to acquire, develop, sell and manage the property. The partners will consist of a corporate general partner owned by the non-resident and a limited partner which will be a trust having a majority of Canadian resident trustees. The project will be financed by way of debt secured by the property and with funds provided by the non-resident. The partnership itself will not be able to borrow funds from a non-resident bank in a manner which is exempt from withholding tax because it is not a corporation. However, the corporate general partner could act as a finance company to borrow the funds from an arm's length non-resident and on-lend the funds to the partnership in a manner which would allow interest to be paid to the banks free of withholding tax.

Income from the sale of the strata units and rental income will be subject to tax in the hands of the limited partner, which is an *inter vivos* trust, at the highest domestic rate. The trust could be made resident in a low tax province. The income will then be capitalized and distributed out as after tax distributions of capital to the non-resident. The corporate general partner can sell strata units without having to obtain clearance certificates and manage the business and affairs of the partnership.

Large corporations tax will also not be payable because the structure does not have any corporate entity holding equity.

5. Example 5 - U.S. Resident Carrying on Business in Canada

(i) Organizational Diagram



(ii) Structuring Issues

All participants are concerned with providing protection against liabilities arising out of the ownership and operation of the clinic. The Canadian investors will hold their interests in the clinic through a corporate vehicle for their own tax planning.

All participants want a single business entity that can transact with the public, collect and remit GST where required and contract with suppliers and obtain regulatory approval. The parties will structure the venture as an LP with a corporate general partner. In order to ensure that the LP retains its status as a Canadian partnership, the U.S. investor will incorporate and organize an Alberta unlimited liability corporation (“AULC”) to hold its partnership interest.

The partnership will be a Canadian partnership for income tax purposes. Payments of interest and other passive income will not be subject to Part XIII tax. The partners will not be prevented from transferring property into the partnership on a tax deferred basis under subsection 97(2) and will have available to them the different provisions of the *Act* relating to the wind-up of partnerships and transfers of property between partnerships including section 98.

All limited partners will get a full flow-through of income and losses subject to their “at risk” amount. All partners will be able to offset the start-up costs against income from other businesses.

The AULC will be treated as a flow-through for U.S. tax purposes and as a separate Canadian resident corporation for Canadian tax purposes. Once the Canadian partnership becomes profitable, the U.S. partner will pay Canadian income tax at the corporate level by the AULC and then should be entitled to U.S. foreign tax credits for the underlying Canadian income tax paid by the AULC. Subject to the thin capitalization rules, the U.S. resident can leverage the AULC and obtain the deduction in Canada from Canadian income tax for interest without a corresponding income inclusion in the hands of the AULC’s U.S. shareholder. Five percent non-resident withholding tax will be imposed on distributions from the AULC to its shareholder. This withholding tax will not be eligible for a foreign tax credit in the U.S.

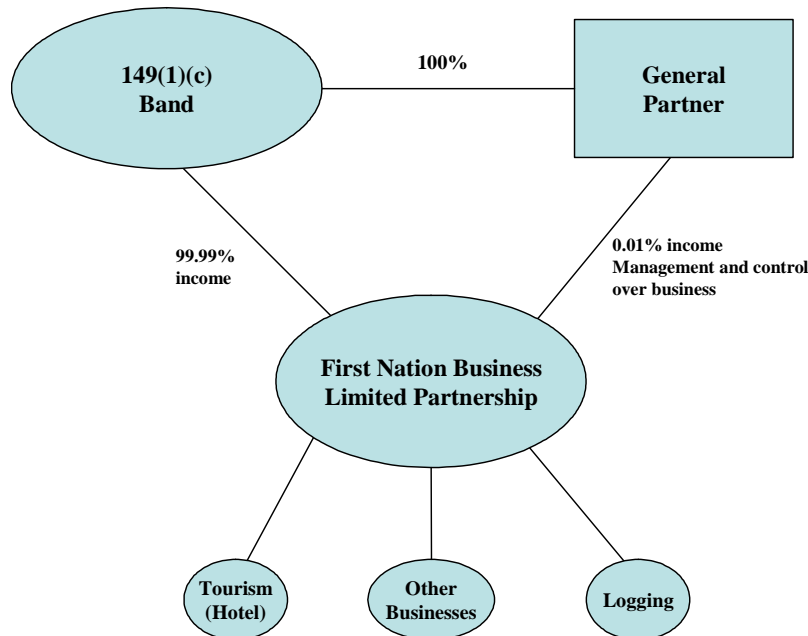
The Canadian compliance and filing requirements for the U.S. partner will be limited to those of the AULC’s business and affairs. It will not be necessary for the U.S. partner itself to file Canadian tax returns and a separate Canadian subsidiary will not in and of itself constitute a permanent establishment under the Canada-U.S. Income Tax Convention.

The US partner’s planning will not impact on the ability of the Canadian partners to take advantage of the SBD and other incentives available to them as partners in a Canadian partnership.

6. Example 6 - Limited Partnership for Business Owned by Native Band

(i) Organizational Diagram

FIGURE 7



(ii) Fact Pattern

The Band is a tax exempt municipal or public body performing a function of government in Canada pursuant to paragraph 149(1)(c). The Band wishes to establish a structure for carrying businesses on and off the Band's territory.

(iii) Structuring Issues

The business structure must provide for limited liability and the ability to exempt all income from income tax pursuant to paragraph 149(1)(c).

If the band were to incorporate a corporation to carry on business, such corporation would be subject to the limitation provided in paragraph 149(1)(d.5) which will only exempt the corporation from tax to the extent that the income from activities carried on outside the geographical boundary of the band does not exceed 10% of its income for the period.

The income earned by the businesses of the First Nation limited partnership will flow through from the First Nation limited partnership to the Band where the exemption under 149(1)(c) can be claimed. This planning has been confirmed by the CRA in a number of technical interpretations.⁶⁹ The Band will enjoy limited liability protection provided it ensures that the control exercised over the general partner does not result in a loss of limited partner status. Safeguards will be implemented to protect the limited liability status including appointing directors who are not members of the Band council.

The exemption in paragraph 149(1)(c) only provides for tax payable under Part I and therefore the partnership structure offers an additional advantage of eliminating the corporate structure and thus ensuring that no large corporations tax is payable on the taxable capital of a corporately held business.

The structure can also be used to exempt the Band from paying B.C. Social Services Tax ("SST") on the property and equipment acquired for use in the businesses as follows:

- (i) the original acquisition of the business assets by the First Nation (or a person who is acting as a bare trustee for the corporation) must occur on a reserve, so that the acquisition is exempt from SST pursuant to s. 87 of the Indian Act
- (ii) the First Nation transfers those assets to the newly incorporated general partner of the limited partnership in return for shares of the corporation.

This transfer of assets will be SST exempt pursuant to Regulation 3.14.1 of the Social Services Tax Act ("SSTA"). To utilize this provision, the First Nation must hold the shares of the corporation for at least 8 months. Normally the transfer of assets to a limited partnership would not come within the tax-free transfers permitted under the SSTA Regulations as they only provide an exemption for transfers to corporations. However, the BC Consumer Tax Branch has issued a tax interpretation that a transfer of assets to a limited partnership is a transfer to the

⁶⁹ See for example Technical Interpretation 2005-0136981. See also Ruling 2005-0159071R3 dated 2006.

general partner, unless the limited partnership agreement states otherwise. Therefore, if the transfer to a limited partnership is made in exchange for shares of the general partner the exemption provided for transfers by shareholders to new corporations is available.

It is preferable to transfer as many of the business assets as possible prior to the commencement of business because neither the limited partnership nor the general partner, once up and running, can directly rely upon the tax exemption in s. 87 of the Indian Act (because this exemption is only available to the band) and they cannot purchase through the Band and then transfer to the general partner (this exemption is only available prior to the commencement of business of the limited partnership).

An alternative planning technique is available to roll further assets into the limited partnership free of SST after the commencement of business. First, the First Nation must acquire the new assets on a reserve. Second, the First Nation transfers those assets to a newly incorporated subsidiary ("Newco") in return for shares of Newco. This transfer is exempt under Regulation 3.14.1. Third, Newco transfers the new business assets to the general partner. This related party transfer of assets will be SST exempt pursuant to Regulation 3.14 of the SSTA. As before, the BC Consumer Tax Branch position considers this to be a non-transaction and therefore there is no incidence for SST. Newco and the general partner must continue as parent/subsidiary for 8 months or the exemption will be lost.

(iv) Variation on Fact Situation: Insertion of a Non-exempt Limited Partner

The Band may wish to carry on one or more of the businesses in partnership with a taxable enterprise. The taxable enterprise will acquire an interest in the limited partnership in exchange for cash or other consideration agreed upon between the parties. If the non-exempt partner deals at arm's length with the Band, allocations of income can be tailored to meet the specific business arrangements between the parties. Depending on the factual situation, it may be possible to allocate additional taxable income to the Band limited partner. Provided that the arrangement is reasonable in the circumstances based on capital and other contributions, this allocation will not be subject to a reallocation under subsection 103(1).

G. CONCLUSION

Partnerships are no longer simply used for small enterprises and professional businesses. The ability to flow out income and provide for limited liability make partnerships a viable alternative to a corporate business structure in a number of situations.

The particular business and tax situation of the business and the participants will determine whether or not the partnership is a viable structure. The ability to reorganize a partnership into a corporate business or a sole proprietorship on a tax deferred basis ensures that the principals are not locked into a partnership structure but can carry out reorganizations at a later date to meet changing circumstances.