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Limited Partnerships

A limited partnership (“LP”) is a specialized vehicle designed to fulfil the needs of particular investors who want to be able to share in partnership profits but limit their liability for partnership losses. An LP is a preferred and commonly used way to structure a relationship between willing parties for a defined business venture. It is used to reduce risk, delineate responsibilities and share profits in a predetermined way.

Every LP must consist of at least one general partner with unlimited liability and one limited partner with limited liability. Unlike general partnerships, however, limited partnerships only come into existence by filing a declaration with the Registrar of Companies.

The general partner has all the rights and powers and is subject to the same restrictions and unlimited personal liability as a partner in a general partnership. By contrast, limited partners have certain fairly narrowly defined rights and their liability is limited to the extent of their contribution.

Limited partners have the right to share in profits and to have their contributions returned. In addition, Section 58 of the British Columbia *Partnership Act* RSBC 1996, c. 348 provides that a limited partner has the same rights as a general partner to:

- inspect books and make copies;
- get full and true information regarding the limited partnership and to be given a complete and formal account of the partnership affairs; and
- to obtain dissolution by court order.

Participation by limited partners in management is subject to significant restrictions. A limited partner may “enquire into the state and progress of the limited partnership business and may advise as to its management” but if the limited partner “takes part in the control of the business”, the limited partner may lose its limited liability. In practice, drawing a distinction between advising as to management and taking part in control has been difficult. The few decided cases disclose no consistent principle.

The benefits to the limited partners (investors) are as follows:

- limited risk – to the amount invested;
- clear delineation of responsibility – one party is a general partner;
- allocation of 100% of losses for potential tax savings;
- provincially regulated;
- regular reporting; and
- regular distributions – capital gains, losses and/or income are flown through to the limited partners in a pre-determined fashion.

One of the most common reasons for investing in an LP is to receive a share of the tax losses generated as well as to benefit from an income stream.

Let’s use an example:

- LP requires a \$2,000,000 pool of investment
- The intent of the LP is to purchase a building worth \$8,000,000
- The LP will obtain \$6,000,000 in lender financing

A limited partner invests \$100,000 which represents 5% of the overall \$2,000,000 pool of investment. With this the LP buys a building worth \$8,000,000 with a mortgage of \$6,000,000 and a net operating income (NOI – i.e., income of the building after all expenses but before mortgage payments) of \$560,000/year.

Of the \$560,000 the LP pays \$460,000 in mortgage payments, out of which \$360,000 is interest (6% on \$6M) and \$100,000 in principal reduction. Hence, the LP will have a cash flow of \$100,000 or 5% of the \$2,000,000 investment.

Initially, the LP flows out 100% or \$100,000 to the limited partners. Thus, on a \$100,000 investment the limited partner could possibly receive a cheque for \$5,000 – which can be deemed as either a return of capital (non-taxable) or taxable income.

In addition to this cash-flow the limited partner may also receive a loss allocation.

Why is there a loss if the LP generates both cash-flow and an operating profit? Because the

building gets depreciated by approximately 4% /year. It should be noted that land does not get depreciated, only buildings. Therefore, if we assume the building is worth \$5,000,000 and the land is worth \$3,000,000, the annual building depreciation will be 4% of \$5,000,000 or \$200,000 (if held for the entire year, less in year one). Thus, the LP's income/loss is calculated as follows:

- \$100,000 cash flow;
- plus \$100,000 in principal reduction in the lender financed debt;
- minus \$200,000 depreciation.

Thus, you may get non-taxable cash-flow and a potential loss allocation.

Note: This is an example only, and does not constitute tax or legal advice.

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