Real Property Vehicles and Structures
GS LAW 6450 3.0 Summer 2009
Course Instructor: Doug Klassen

Title: The use of partnerships as a vehicle to own real property.

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Introduction

The law of partnerships evolved as part of the common law in England which eventually was codified. There is no federal legislation governing partnerships. In Quebec, partnerships are governed by the Civil Code [1].

All other Canadian provinces have partnership legislation[2] based on Britain's *Partnership Act*, *1890*. In these jurisdictions, therefore, there is a substantial degree of uniformity.

Moreover, the rules of equity and common law applicable to partnerships continue in force, except so far as they are inconsistent with applicable legislation [3].

In Canadian common law provinces, there are three different kinds of domestic partnership: the general partnership, the limited partnership, and the limited liability partnership.

Unlike in general partnerships, in limited partnerships provincial and territorial legislation is not uniform [4]. The most relevant distinction relates to the point at which limited partners lose the liability shield if they participate in, or control, management of the business.

In this paper we will examine the liabilities involved and the tax implication when adopting a partnership structure as a vehicle to carry on business and hold real estate. We will review the legal rules that apply to the property of a partnership and we will also discuss the main distinctions between partnerships and co-ownerships vehicles to own real property.

The Limited Liability Partnership analysis will not form part of the scope of this paper since it appeals almost exclusively to firms of lawyers, chartered accountants and certified general accountants.

General Partnerships

The partnership is not a legal entity separate from the partners composing it[5]. While partnerships frequently have a name that is distinct from the name of the partners, the law does not recognize a separate entity. Yet, in some instances the partnership may be considered as a unit for some purposes. For instance the *Rules of Civil Procedure* enable partners carrying on business in Ontario to sue or be sue in the firm name. However, the courts have recognized that, "Where you have a rule which enables you for the sake of convenience to bring and to obtain judgement against a firm, you are in truth bringing an action against the persons who constitute the firm, and the judgement is really a judgment against the individuals"[6].

According to the provincial partnership Acts, partnership exist anytime there are "... persons carrying on business in common with a view to profit..." [7]

Determining whether a partnership exists may result sometimes difficult. The courts will look not only at the intention of the parties disclosed in their agreement, but also at their actual behaviour. In *Adam* v. *Newbigging* [8], Lord Halsbury stated:

> If a partnership in fact exists, a community of interest in the adventure being carried on in fact, no concealment of name, no verbal equivalent for the ordinary phrases of profit or loss, no indirect expedient for enforcing control over the adventure will prevent the substance and reality of the transaction being adjudged to be a partnership; . . .

This approach was confirmed by Collins M.R. in *Weiner* v. *Harris* [9]:

> Two parties enter into a transaction and say "It is hereby declared there is no partnership between us." The Court pays no regard to that. The Court looks at the transaction and says "Is this, in point of law, really a partnership? It is not in the least conclusive that the parties have used a term or language intended to indicate that the transaction is not that which in law it is."

Liability of the Partnership and Risk Management

A general partnership involves more commercial risk for the partners than any other vehicle for carrying on business. In a partnership, each partner is jointly and severally liable with the other partners to the full extent of his or her personal assets for all debts and obligations of the firm incurred while a partner [10].

In addition, one of the main principles governing the relation of the partners with third parties is that each partner is the agent of the partnership and the other partners when acting in the normal course of partnership business or what reasonably appears to be so [11]. Thus, according to the law of principal and agent, one partner's act or omission binds all partners and the partnership. The actions of the partner will not be binding only when it is evident that the partner is not acting within the scope of the partnership's business, or when a third party is aware that the partner is not authorized to act for the partnership in a particular transaction [12].

Unless otherwise is provided in the partnership agreement, a partnership automatically terminates on the death, bankruptcy or withdrawal of any of its partners [13].

In order to ensure the protection of the persons dealing with partnerships, the rules governing the relationship between partnerships and third parties are mandatory. General partners' exposure to joint and several liability is extremely high. Yet, there are some steps that may be taken to minimize being found a partner, such as holding the partnership interest in a corporation, and creating indemnification provisions in the partnership agreement, as well as including control mechanisms to reduce the likelihood of unauthorized liabilities, and arrangements to allocate risk among the partners. The firm can also partially protect itself through liability insurance.

Limited Partnerships

An alternative to a general partnership model is the limited partnership, which shields limited partners from liability the extended liability described above, and, moreover, a limited partner's liability is limited to his/her agreed contribution. Thus, unlike in a general partnership, in a limited partnership, one or more general partners have all the rights and powers and are subject to all the restrictions and liabilities of a partner in a general partnership, while the limited partners contribute capital and share profits and have their liability limited to the value of their investment provided they do not take part in the control of the partnership business[14]. Unlike a general partner, a limited partner may be an employee of the partnership [15].

Participation by limited partners in management is subject to significant restrictions. Although a limited partner may "enquire into the state and progress of the limited partnership business and may advise as to its management" [16], it is important to note that a limited partner can lose his or her limited liability and become a general partner if he or she takes part in control of the business [17]. The line between advising as to management and taking part in control is difficult to draw. What constitutes "control of the business" is not statutorily defined; the determination is made on a case-by case basis.

In *Haughton Graphic Ltd.* v. *Zivot* [18], in interpreting Alberta's *Partnership Act* [19], the Ontario Superior Court held that any time a limited partner was an employee, officer, or director of a corporate general partner and, in that capacity, took part in the control of the business, he would be liable personally as a general partner for the obligations of the partnership [20]. This approach, however, has not been followed in subsequent cases.

In *Nordile Holdings Ltd* v. *Breckenridge* [21], the Court held that "where individual limited parts act only in their capacities as directors and officers of a corporate general partner, they are not liable as general partners".

A limited partner will also lose limited liability if he/she permits a distinctive part of his or her name to appear in the firm name and a creditor has no knowledge that the limited partner is not a general partner [22].

With the exception of Manitoba and Quebec, provincial legislation provides that if an extra-provincial limited partnership is registered in the province, the limited partners continue to enjoy limited liability. The laws of the jurisdiction under which an extra-provincial limited partnership is organized govern its organization and internal affairs and the limited liability of its limited partners.

A firm is required to fill out a declaration of limited partnership [23] and the partners must enter into a written limited partnership agreement [24]. The declaration expires after five years unless renewed [25].

In addition to the tax advantages examined below, a limited partnership could be an attractive vehicle for syndication of real estate investment since an investor may buy into a real estate project on the basis of multiples of units. A limited partnership can be tailored to fit individual needs and the desired degree of participation in the project. Moreover, limited partnership units may be eligible for listing on a stock exchange, increasing the investment's liquidity.

Property

As expressly provided in some partnership statutes, partnership property consists of all property contributed to the partnership as well as all property acquired on its behalf or for the purpose and in the course of the partnership business [26].

Property deemed to be partnership property is not divisible among the partners in specie [27] even if title is retained by a partner. A partner loses his individual beneficial interest in property contributed to a partnership, unless otherwise provided in the partnership agreement. A partner is entitled only to the sale and division of the proceeds of partnership property on dissolution of the partnership, after the discharge of all partners' liabilities [28].

Because a partnership is not a legal person, it cannot acquire or hold a registered interest in real property. In order to acquire and hold real property, the partnership requires an individual or corporation to become a registered owner. Thereby, title would be held subject to an unregistered declaration of trust or written trust agreement. In limited partnerships, the only entity legally capable of holding title to the real property is the general partner [29].

A limited partner is entitled to a return of his or her contribution upon dissolution of the partnership. This is to happen at the time specified in the limited partnership agreement or after six months' written notice to all partners if the agreement is silent, or when all partners consent to the return of the contribution [30]. However, even after the contribution of the limited partner has been returned, he/she is liable to creditors to the extent of the amount returned, with interest, it the claim arose before the return of the contribution.

Taxation

The partnership itself is not a taxable entity; yet, it is recognized as a separate entity for the purpose of computing income. Thus, a partnership has to file an information return for tax purposes. The income or loss of the business carried on by the partnership is determined at the partnership level and then allocated to the partners and computing their income annually regardless of whether distributions have been made from the partnership to the partners. Each member of the partnership is required to file a partnership information return showing, among other things, the names of the partners and their share of each source of partnership income or loss.

The losses incurred by a partnership flow through to the members and can be used to shelter other sources of income. The ability to flow partnership losses out to the partners is a significant advantage over the use of other vehicles, particularly in cases where losses are anticipated in the initial stages of the venture. In addition, in a partnership there is no potential for double taxation. In the case of a limited partnership a limited partner can only deduct his share of limited partnership non-capital losses to the extent of the amount for which the limited partner is at risk.

As, for tax purposes, the partnership is considered a separate entity, the determination as to whether to take discretionary deductions, such as capital cost allowance, has to be made at the partnership level and not individually by the partners. All partners receive their aliquot share of expense whether they can deduct it or not.

Transfers of assets to and from the partnership constitute "dispositions" for tax purposes. Partners will be deemed to have sold the assets at fair market value, regardless of the actual price the partnership paid [31]. However, a number of rollover provisions are available in order to defer any gain on the transfer of property, including real estate inventory. Section 97 (2) of the *Income Tax Act* (*ITA*) permits the transfer of property with an accrued capital gain to a partnership without immediate tax consequences. In addition, there are other rollovers available on the transfer of assets from the partnership to partners on dissolution or on the incorporation of the partnership [32].

Co-ownership

Co-ownership is a term used to describe the arrangement where two or more persons own a particular property, each owning an undivided interest. Co-ownership arrangements are mainly governed by the common law, particularly contract law, and also to the law relevant to the underlying asset. Where the co-owned asset is real property, each province and territory has partition legislation that can be invoked in the case of a dispute [33].

But, partnership legislation provides that holding property in some form of common ownership does not, of itself, create a partnership in relation to the property, even if the co-owners share profits made from the use of the property [34].

In order to be characterized as partners, there must be something more than simply owing property and sharing the profits from it. Some substantial management or other business activity must be present. Determining when a partnership will be found in a real estate co-ownership situation is challenging since, in almost all cases, some management will be required. Blair J.A. wrestled with this issue in *A.E. LePage Ltd.* v. *Kamex Developments Ltd.*[35]:

> Whether or not the position of co-owners becomes that of partners depends on their intention as disclosed by all the facts of the case. It is necessary to determine whether the intention of the co-owners was to "carry on business" or simply to provide by an agreement for the regulation of their rights and obligations as co-owners of a property. The learned trial Judge considered that the intention of the co-owners to purchase the building, hold it as an investment and sell it for profit constituted them as partners in a business carried on for profit. With respect, I am of the opinion that the mere fact that co-owners intend to acquire, hold and sell a building for profit does not make them partners.
>
> In this case the intention of the parties to maintain their rights as co-owners of the property is clear beyond doubt from the documents. In addition, it should be noted that the appellants wished to identify and keep separate their beneficial interests in the property for income tax purposes. Their intention would have been defeated if they were regarded as a partnership and the apartment building had become the property of the partnership. The fact that they are obliged by their agreement to offer a right of first refusal to the other co-owners in the event of sale is not inconsistent with their basic right to deal with their respective interests in the property.

Clearly, the risk of an unwanted "partnership" being found is real, and the result, serious. A significant difference between ownership of property by co-owners instead of by a partnership is that, subject to the terms of any agreement, each co-owner may deal with his/her interest in the common property as his own, without the consent of the others, whereas partnership property is governed by the requirements of approval of the partnership. In addition, unlike partners, co-owners are not agents of each other, and therefore the actions or omissions of one co-owner do not bind other co-owners.

Where multiple ownership of real estate is contemplated, a co-ownership instead of a partnership may be more convenient from a tax point of view, if owners wish to claim capital cost allowance at different times or at different rates. Unlike in a partnership, in the co-ownership each owner can make his or her own claim for capital cost allowance based upon his or her separate circumstances and interest(s) in the property: *ITA*, paragraph 20(1)(a) and Part XI of the *Regulations* under the *Act*. Under the rental property rules in the *ITA*'s *Regulations,* an owner can only claim capital cost allowance in respect of rental real estate to the amount of the owner's net rental income.

On the other hand, unlike in a partnership, the entry of a new co-owner will always result in a disposition of a portion of the subject property to the new co-owner.

Conclusions

In carrying on business using a partnership structure, an individual runs the risk of being found jointly and severally liable with the other partners to the full extent of his or her personal assets for all debts and obligations of the firm incurred while a partner. This exposure can be minimized by taking the appropriate steps like holding the partnership interest in a corporation or creating indemnification and control mechanism provisions in the partnership agreement. The firm can also partially protect itself through liability insurance.

Despite the risk above, partnership may be an attractive vehicle for individuals with high incomes from other sources. By investing in a limited partnership, the investor receives a share of tax losses generated by the partnership to offset other taxable income.

An alternative to a general partnership is the limited partnership. The liability of the limited partner is limited to his agreed contribution. However, a limited partner runs the risk of losing his or her limited liability if he or she takes part in control of the business, thereby becoming a general partner.

A limited partnership could be an attractive vehicle for syndication of real estate investment since (i) an investor may buy into a real estate project on the basis of multiples of units, (ii) a limited partnership can be tailored to fit individual needs and the desired degree of participation in the project, and (iii) the units of a limited partnership may be eligible for listing on a stock exchange increasing the liquidity of the investment.

Although the partnership is not a legal entity separate from the partners composing it, for the purpose of computing income the partnership is a separate entity. Therefore, the determination as to whether to take discretionary deductions (such as capital cost allowance) has to be made at the partnership level and not individually by the partners.

The partnership property is not divisible among the partners. Moreover, a partnership cannot acquire or hold a registered interest in real property. In order to acquire and hold real property, a partnership requires an individual or corporation to become a registered owner.

Another business structure commonly used to hold real estate is the co-ownership. Unlike partners, co-owners are not agents of each other and therefore the acts or omissions of one co-owner will not bind another. A co-owner may also deal with his/her interest in the common property without the consent of the others.

Determining when partnership will be found in real estate co-ownership cases is challenging since, in almost all real estate holdings, some management will be required. Partnership characterization cannot be avoided simply by including language in the agreement denying that relationship.

Co-ownership may be preferable to a partnership where the owners wish to claim capital cost allowance at different times or at different rates. Unlike in a partnership, in the co-ownership each owner can make his or her own claim for capital cost allowance based upon his or her separate interest in the property.

Foot notes:

1. Civil Code of Quebec , Art. 2186-2266.

2. See Ontario *Partnerships Act*, R.S.O. 1990, c. P.5 [OPA]; Alberta *Partnership Act*, R.S.A. 2000, c.P-3 [APA]; British Columbia *Partnership Act*, R.S.B.C 1996, c. 348 [BCPA]; and Nova Scotia *Partnership Act*, R.S.N.S. 1989, c. 334 [NSPA].

3. *OPA*, s. 45

4. *Supra* Note 2.

5. Thorne v. New Brunnswick (Workmen's Compensation Board) (1962), 33 D.L.R.(2d) 167 (N.B.C.A.); Craig Brothers v. Sisters of Charity, [1940] 4 D.L.R. 561 (Sask. C.A).

6. Re *Frances Handford & Co.*, [1899] 1 Q.B. 566 as cited in *Welcome Wagon v. Meyers Studios* (1956) 6 D.L.R. (2d) 373 (N.B.Co.Ct.)

7. See *OPA*, s.2, *BCPA* s.2 and *NSPA* s.4.

8. *Adam et al.* v. *Newbigging et al.* (1888), 13 App. Cas. 308 (H.L.) at 315.

9. *Weiner* v. *Harris*, [1910] 1 K.B. 285 (C.A.) at 290.

10. See *OPA*, ss. 10-13; *BCPA*, ss. 11- 15; and *NSPA*, ss. 12-15.

11. See *OPA*, s. 6; *BCPA*, s. 10; and *NSPA*, s. 8.

12. See *OPA*, s. 9; *BCPA*, s. 10; and *NSPA*, s. 11.

13. *Supra* note 3, s. 33 (a)

14. Lehndorff General Partners Ltd.[1993] O.J. No.14 (Ont. Gen. Div.) at 29-37

15. *Limited Partnerships Act*, R.S.O. 1990, c. L.16. , s. 12

16. *Ibid.* at s.s 12(2)

17. *Ibid.* at s. 13

18. *Haughton Graphic Ltd. V. Zivot*,(1986), 33 B.L.R. 125 (Ont. H.C.J.), aff'd 38 B.L.R.xxxiii (C.A)

19. *APA*, supra note 1.

20. *Supra* note 18 at 134

21. *Nordile Holdings Ltd v. Breckenridge* (1992), 66 B.C.L.R. (2d) 183 (C.A), aff'g (21 February 1991), (B.C.S.C.)

22. S*upra* note 15, ss. 6(2)

23. *Ibid.* at ss.3 (1)

24. *Ibid.* at ss. 4(1) and ss. 33(1)(a)

25. *Ibid.* at ss. 3(3)

26. *OPA,* ss.21(1); *NSPA*, ss. 23(1)

27. *Porter* v. *Armstrong*, [1926] S.C.R. 328, 2 D.L.R. 340.

28. *Supra* note 3, at s. 39.

29. Kucor Construction & Developments & Associates v. Canada Life Assurance Co. (1998), 114 O.A. C. 201, 167 D.L.R. (4th) 272, 41 O.R. (3d) 577, 21 R.P.R. (3d) 187 (C.A.).

30. *Supra* note 15 at s. 15.

31. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) at ss. 97(1)

32. Ibid at ss. 8592) and (3), and ss. 98(3), (5) and (6).

33. Such as the *Partition Act*, R.S.O. 1990, c.p.4.

34. OPA, sec.3.1; BCPA, s.4; and NSPA, s.5

35. *A.E. LePage Ltd.* v. *Kamex Developments Ltd. et al.* (1977), 16 O.R. (2d) 193, 78 D.L.R. (3d) 223 (C.A.).