

General Partnerships

Key Issues Throughout the Partnership Life Cycle

Introduction

- Background
 - Historical Origins and Sources of Law
 - Characteristics of a Partnership
 - Co-ownership vs. Partnership
- The Partnership Agreement: Dealing with the Life Cycle
 - Default Rules under the Ontario *Partnerships Act*
 - Five fundamental drafting considerations
 1. Capital Contribution
 2. Profit and Loss Allocation
 3. Governance
 4. Changes to Partners and Partnership
 5. Dissolution/Bankruptcy

Historical Origins & Sources of Law

Historical Origins

- Roman Empire: the “*Societas*”
- Medieval Associations: Capital Investment
- Rule in *Grace v Smith* (1775) 96 ER 587 (KB) (quasi-partnerships)
- Reformation: *Cox v Hickman* (1860), 11 ER 431 (HL)
- Further modifications of presumptions: *Bovill’s Act*, 1865, 28 & 29 Vict c 86

Further Statutory Modification

- *Partnership Act, 1890, 55 & 54 Vict c 39 (UK)*
 - Reform Legislation – Not a complete code.
 - Newfoundland 1892
 - British Columbia 1894
 - Manitoba 1897
 - Alberta 1899
 - Nova Scotia 1911
 - Ontario 1920
- *Limited Partnerships Act, 1907, 7 Edw 7, c24 (UK)*

Characteristics of a Partnership

Statutory Definition

- A relation
- That subsists between persons
- Carrying on a business
- In common
- With a view to profit
- But not:
 - Members of an incorporated company or association incorporated or registered under authority of any special Act in force in Ontario or elsewhere
- (s. 2, ONPA)
- *Continental Bank of Canada v. R.* [1998] 4 C.T.C. 119 (S.C.C.)

Presumptions of Partnership

- The receipt by a person of a share of the profits of a business is proof, in the absence of evidence to the contrary, that the person is a partner in the business. (ONPA, s. 3 Rule 3)
- BUT:
 - Joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything so held or owned
 - The sharing of gross returns does not of itself create a partnership
 - The advance of money by way of loan with a rate of interest varying with the profits, or on the basis of a receipt of a share of the profits arising from carrying on the business does not create a partnership provided the contract is in writing and signed by or on behalf of all parties
 - A person receiving by way of annuity or otherwise a portion of the profits of a business in consideration of goodwill from the sale of the business does not create a partnership

Not a Juridical Person

- Persons who have entered into partnership with one another are collectively known as a firm, and the name under which their business is carried out is known as a firm (s. 5 ONPA)
- However:
 - Can sue and be sued in firm name as convenient short-hand
 - Many statutes treat as a juridical person (next slide)

Examples of Statutes

- *Apprenticeship and Certification Act, 1998, SO 1998, c 22*
- *Consumer Reporting Act, RSO 1990, c C.33*
- *Consolidated Hearings Act, RSO 1990, c C.29*
- *Commodity Futures Act, RSO 1990, c C.20*
- *Community Small Business Investment Funds Act, 1992, SO 1992, c 18*
- *Electricity Act, 1998, SO 1998, c 15, Sch A*
- *Energy Consumer Protection Act, 2009, SO 2010, c 8*
- *Environmental Assessment Act, RSO 1990, c E.18*
- *Gaming Control Act, 1992, SO 1992, c 24*
- *Human Rights Code, RSO 1990, c H.19*
- *Limited Partnerships Act, RSO 1990, c L.16*
- *Ontario College of Trades and Apprenticeship Act, 2009, SO 2009, c 22*
- *Paperback and Periodical Distributors Act, RSO 1990, c P.1*
- *Residential Tenancies Act, 2006, SO 2006, c 17*
- *Retail Sales Tax Act, RSO 1990, c R.31*
- *Securities Transfer Act, 2006, SO 2006, c 8*
- *Small Business Development Corporations Act, RSO 1990, c S.12*
- *Technical Standards and Safety Act, 2000, SO 2000, c 16*
- *Tobacco Tax Act, RSO 1990, c T.10*
- *Transboundary Pollution Reciprocal Access Act, RSO 1990, c T.18*

Practical Issue: Firm Contracts

- When change in partners, the partners may agree to adopt all existing rights and obligations of former partnership
- However, that is an agreement between them
- Assignment provisions in third party contracts may be triggered unless it can be inferred that the contract was to be performed by the firm as from time to time constituted
- May turn on whether all of the partners signed or whether signed in the firm name

Partnership for Tax Purposes

- Partnership is not a separate tax-paying entity, although it is deemed to be a person for certain purposes under the Income Tax Act (“ITA”)
- Most importantly, a partnership is treated as a separate person for computation of partnership income, which will be allocated to, and taxed in the hands of, the partners (allocation issues discussed later in presentation)
- Tax reporting requirements for partnership (T5013) – subject to administrative exceptions
- Tax reporting for individual partners
- Ownership of property v. ownership of partnership interest
 - Partners typically not viewed as owning the assets of the partnership, subject to certain specific exemptions

Tax Implications of Being a Partner

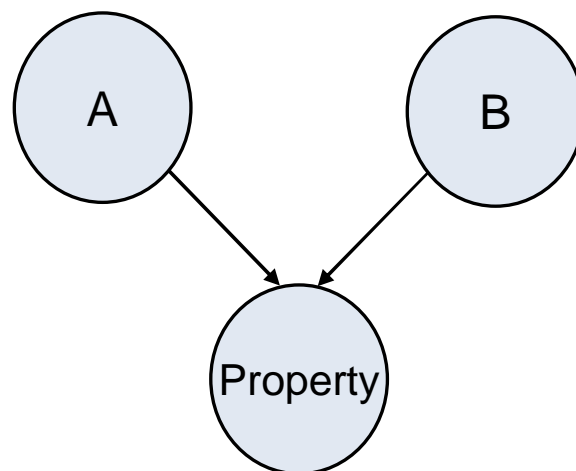
- Each partner carries on the business of the partnership
 - “Silent” or “inactive” partners still considered to carry on the same activities as the partnership
- If non-resident partner, you are carrying on business in Canada
 - reporting/tax paying obligations

Co-Ownership vs Partnership

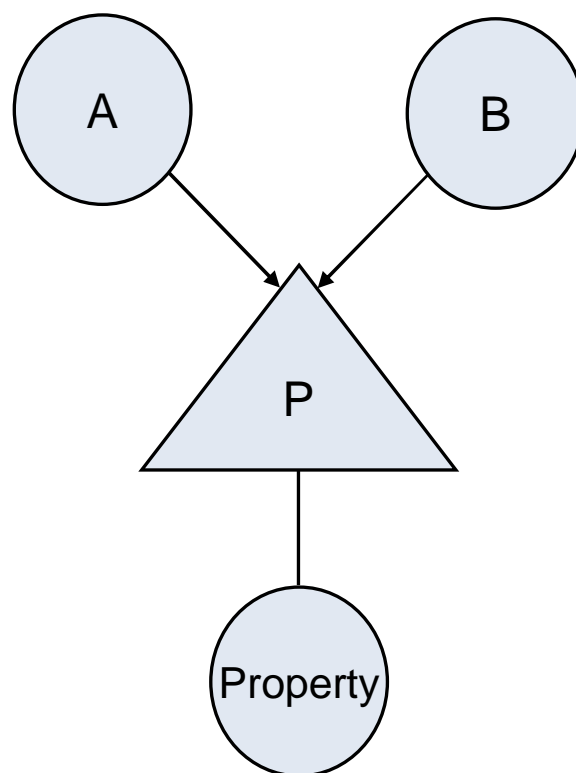
Co-Ownership Characteristics

- A co-owner can own assets separately – direct interest
- Co-owners do not have authority to bind except in limited circumstances
- A co-owner is not an agent for other co-owners
- No “default” rules for co-ownerships
- Not a legal person for tax purposes
- Factual – not presumptive – joint and several liability

Co-Ownership



Partnership



Mutual Agency

- Every partner is an agent of the firm and of the other partners for the purpose of the business of the partnership
- All acts of a partner carrying on in the usual way the business of the firm bind the firm and the other partners
 - Indoor management rule applies
- Exceptions
 - If a partner pledges the credit of the firm for a purpose not connected with ordinary business, firm is not bound unless partners authorized (although individual partner still liable)
 - Deeds and negotiable instruments need to be signed by all partners

Fiduciary Duties

- Varies depending on the nature of the partnership and the contractual duties and responsibilities of the partner
- Prohibition on competing with the partnership (ONPA, s. 30)
- Duty to account for personal profit (ONPA, s. 29)
- Misuse of partnership assets (ONPA, s. 21)

Ownership of Assets

- Not joint ownership of assets
- Instead: entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm
 - ONPA, s. 24 Rule 1
- Where partnership property held in the name of a partner, it is held on trust for the firm (that is, the collectivity of the partners) because it must be employed exclusively for the purpose of the partnership
 - ONPA, s. 21(1)

Illustration – Real Property (Purchases)

- Unless the contrary intention appears, property bought with money of the firm is deemed bought on account of the firm
- (ONPA, s. 22)
- Where land or any heritable interest therein becomes partnership property, unless the contrary intention appears, it is treated as between the partners, as personalty
- (ONPA, s. 23)
- HOWEVER
 - If co-owners share profits from co-owned land, any land bought with profits is co-owned, not partnership property
(ONPA, s. 21(3))

Illustration – Real Property (Death)

- The legal estate or interest in land that belongs to a partnership devolves according to the nature and tenure thereof and the general rules of law thereto applicable, but in trust, so far as necessary, for the persons beneficially interested in the land under this section
- (ONPA, s. 21(2))

Joint Liability: Contract

- All partners jointly liable for debts and obligations of the firm incurred while the person is a partner
- Exception
 - LLPs and LP
 - Estate of deceased partner is also severally liable after individual estate debts are satisfied (i.e. liable for proportionate share)
 - Estate of insolvent partner is joint and severally liable after individual bankrupt estate debts are satisfied
- Liability commences with admission as a partner
- (ONCA, ss. 10, 11, 13, 18 & BIA)

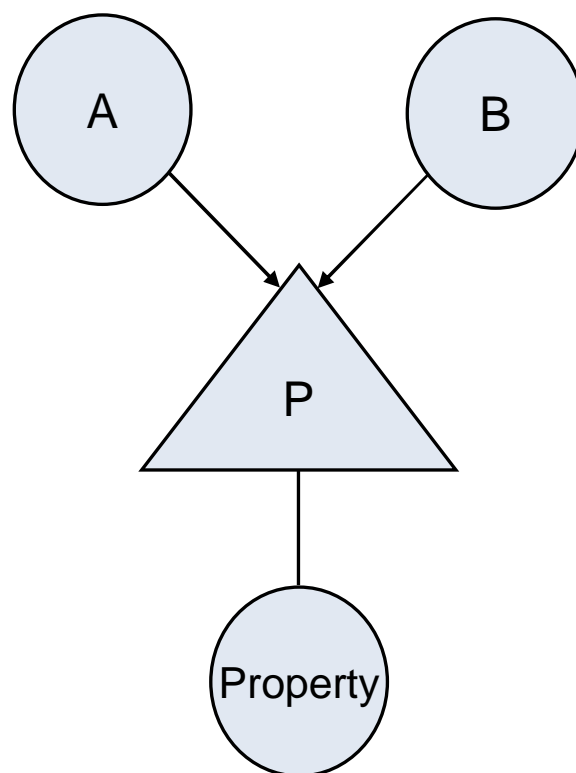
Joint & Several Liability: Tort

- Firm and co-partners are jointly and severally liable for wrongful acts and omissions of a partner acting in the ordinary course of business or with the authority of other partners
- Exception
 - Exception is LLPs (professional negligence) and LPs in an LP
- (ONPA, ss. 10, 11, 13, 18 & BIA)

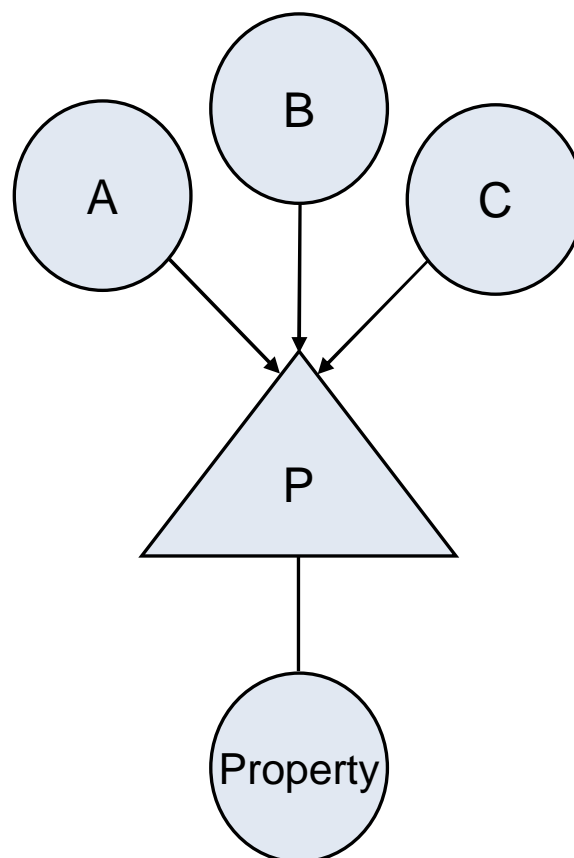
The Partnership Agreement

The Life Cycle of the Partnership

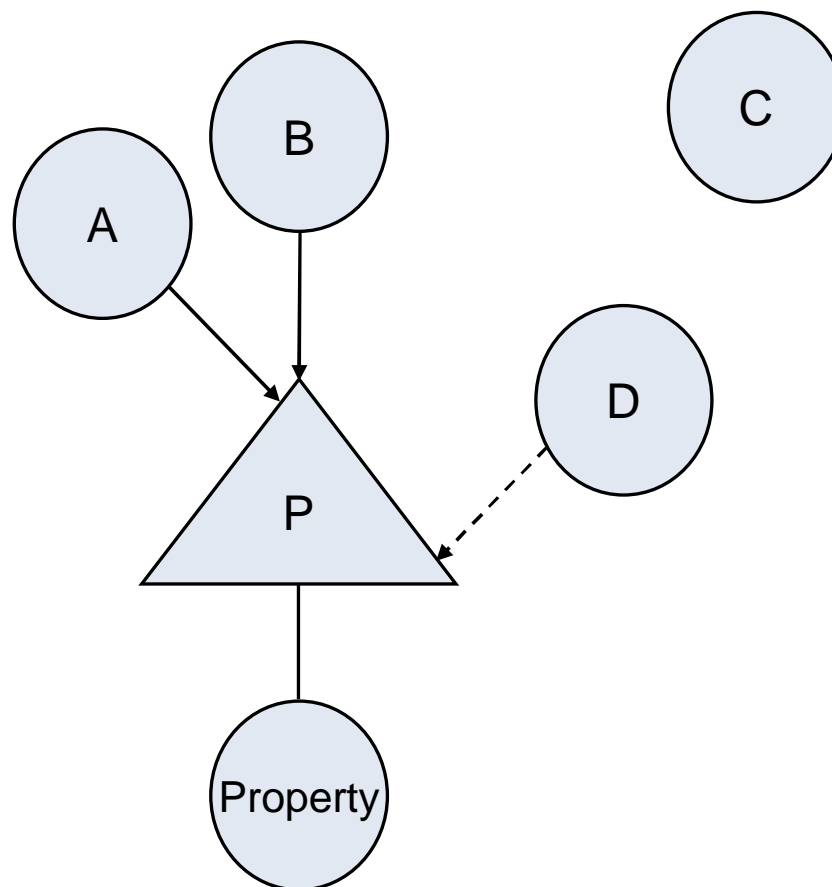
Formation of Partnership



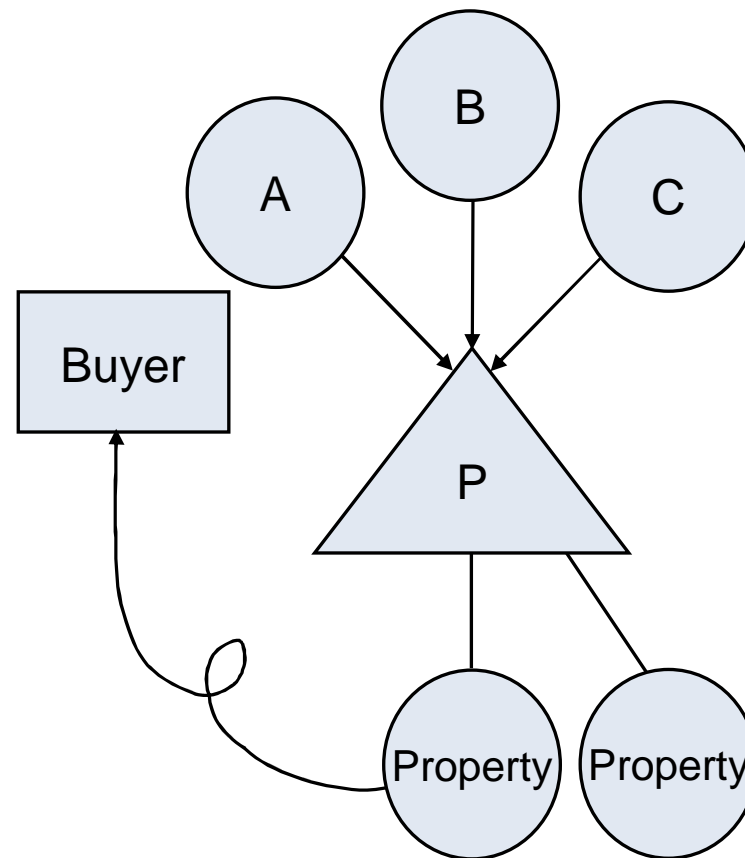
Addition of New Partners



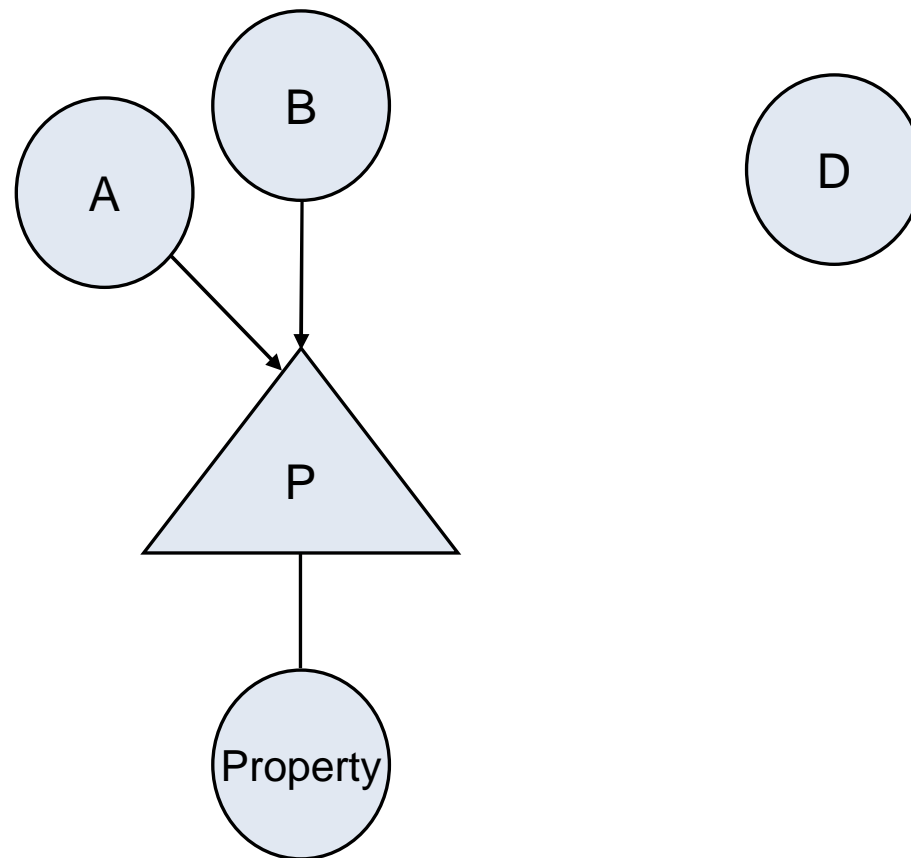
Sale of Partnership Interest



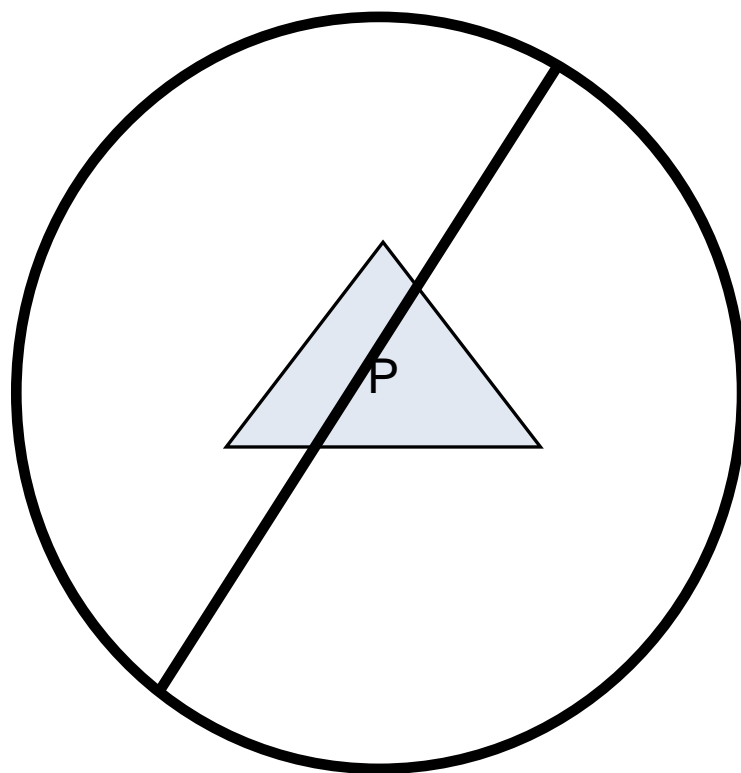
Sale of Property by Partnership



Removal / Death / Retirement of a Partner



Termination / Dissolution of Partnership



Default Rules under the Ontario *Partnerships Act*

Default Rules: Equality

- Equality of Interest
 - Each partner shares equally, both in the capital of the partnership and in any profits, and must contribute equally to any losses incurred (ONPA, s. 24, rule 1)
- Mutual Indemnification
 - Each partner is entitled to be indemnified in respect of payments made or liabilities incurred in the ordinary course of the partnership business, or to preserve the business or property of the firm (ONPA, s. 24, rule 2)
- Equality of Voice
 - Each partner has a right to participate in the management of the partnership business (ONPA, s. 24, Rule 5)
- Majority Vote
 - Decisions regarding ordinary matters connected with the partnership business may be decided by a majority of the partners (ONPA, s. 24, Rule 8)

Default Rules: Fundamental Changes

- Admission of Partner
 - Admission of a new partner requires unanimous consent (ONPA, s. 24, Rule 7)
- Change in Nature of Business
 - Any change in the nature of the partnership business requires unanimous consent (ONPA, s. 24, rule 8)
- Expulsion
 - A majority of partners may NOT expel a partner (ONPA, s. 25)
- Variation of Default Rules
 - Any variation of the default rules requires unanimous consent (ONPA, s. 20)

Default Rules: Transfers & Termination

- Assignments & Security

- Any person who takes an assignment of a partner's interest, whether as a purported transfer or for the purpose of taking security for the performance of some obligation of the partner, has no rights as a partner, except to receive the share of the partnership profits to which the assigning partner would otherwise be entitled (ONPA, s. 31)

- Termination: Indefinite Partnerships

- Any partner may terminate a partnership of no fixed duration by giving notice to the others (ONPA s. 26 & s. 32(c))

- Termination: Fixed Duration or Single Undertaking

- Partnership for a fixed duration or a single undertaking expires at the end of that duration or undertaking (ONPA, s. 32(a)-(b))

Default Rules: Capital and Records

- No interest on required capital contribution
 - A partner is not entitled to interest on capital contributed in calculation of net profits for distribution (ONPA, s. 24, rule 4)
- Interest on excess capital contribution
 - A partner is entitled to interest at 5 percent per year on contributions to the partnership in excess of the amount that he has agreed to contribute (ONPA s. 24, rule 3)
- Books and records to be kept at principal place of business
 - (ONPA, s. 24, rule 9)
- Each partner may inspect and copy books and records
 - (ONPA, s. 24, rule 9)

Five Fundamental Considerations in Drafting a Partnership Agreement

1. Capital Contributions

Capital Contributions

- What is a capital contribution?
 - Financing of partnership
- Tracking capital contribution
 - Does it have to be cash?
 - Becomes partnership property
 - Capital accounts
- How much does each partner have to contribute and when?
 - Statutory requirements
 - Initial contribution
 - Subsequent contributions
 - Who determines amount?
 - Interest on capital

Capital Contributions

- How does capital get refunded?
 - Surplus capital
 - Withdrawals of partners
 - Set-offs and holdbacks against capital
- Alternative arrangements
 - Income/Non-Equity Partners
 - Limited Partners

2. Profit & Loss Allocation

Profit & Loss Allocation

- Statutory requirements
- Partnership interest
 - What does it mean with respect to profit and loss?
 - How is partnership interest calculated?
 - Fixed vs. variable partnership interest
 - Who determines partnership interest?

Profit & Loss Allocation

- How is profit calculated?
 - Calculations at partnership level
- Allocations of taxable income and losses
 - Draws vs. Income
- Cash distributions
 - Calculation and timing
 - Holdbacks and reserves
 - Set-offs

Capital vs. Current Account

Contributions & Allocations: Tax Implications

- Partners need to track several different “accounts” when contributing property – can lead to confusion
 - “Commercial accounts”
 - Capital account
 - Cash distribution entitlements
 - “Tax accounts”
 - Tax cost of partnership interest (“ACB”)
 - Tax allocation of partnership profits/losses
- All of these accounts are related to each other and need to be considered when contributing property, but they do not necessarily track each other

Contributions & Allocations: Tax Implications

- Structuring the contribution
 - Becoming a partner typically involves a contribution of cash, but commonly involves the contribution of other property
 - Contributions can be taxable events (appreciated property)
 - Tax-deferred “rollover” may be available (ITA section 97) – but must be a “Canadian partnership”
 - All partners must be residents of Canada
 - Significant consequences to partnership and other partners if not a “Canadian partnership”
 - Certain tax-deferred rollovers unavailable
 - Withholding tax implications for payments made and received by the partnership
 - Corporate partners
 - One method of protecting Canadian partnership status
 - Fiscal year-end issues

Contributions & Allocations: Tax Implications

- Tax Allocations
 - Flexibility
 - Preferred tax allocations
 - There are limits to flexibility
 - Subject to reallocation by CRA if principal reason for the allocation is to reduce tax and the allocation is unreasonable in the circumstances (ITA subsection 103(1))
 - If partners are non-arm's length, CRA can reallocate if allocation is unreasonable in the circumstances...lower standard than arm's-length partners (ITA subsection 103(1.1))

Contributions & Allocations: Tax Implications

- **Becoming a Partner – Tax Cost of Partnership Interest**
- Tax cost (“adjusted tax base” or “ACB”) of a partner’s interest in the partnership is relevant for future dispositions of partnership interest

Contributions & Allocations: Tax Implications

- **Becoming a Partner – Tax Cost of Partnership Interest**
- ACB equal to amount paid for the initial acquisition of the partnership interest, subject to certain adjustments
- Upward adjustments (ITA paragraph 53(1)(e))
 - Partner's allocated share of partnership income for the period (adjusted after fiscal period ends)
 - Additional capital contributions to the partnership (subject to "conferral of benefit" rules) (immediate addition)
- Downward adjustments (ITA paragraph 53(2)(c))
 - Partner's allocated share of partnership losses for the period (adjusted after fiscal period ends)
 - Amount of any distributions or withdrawals of capital made to or by the partner (immediate reduction)
- ACB of general partnership interest can be negative without triggering immediate capital gain...but watch out for negative basis in limited partnerships

Contributions & Allocations: Tax Implications

- Becoming a Partner – Tax Cost of Partnership Interest
- ACB Timing issues
 - Some adjustments made only after end of partnership's fiscal period
 - Others made regardless of end of fiscal period
 - Problems when (i) partner ceases to be partner at any time other than fiscal period end, i.e. sale of partnership interest, or (ii) partnership dissolves (we'll come back to this)

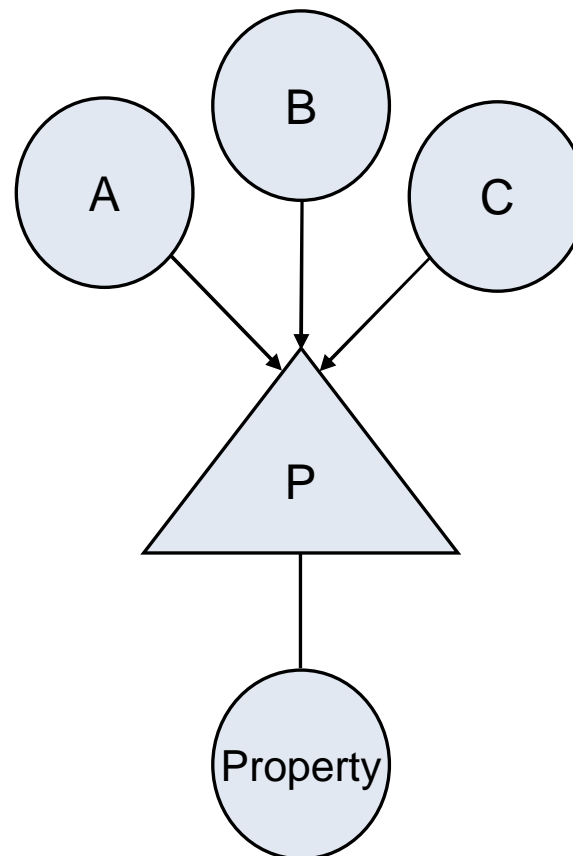
3. Governance

Governance: Business Management

- Statutory requirements vs. flexibility of agreement
 - How much control is required?
 - Authority to bind
- Delegating management responsibilities
 - Management and compensation committees
 - Managing partner
 - Reporting requirements
- Partner meeting and voting
 - Key issues for determination
 - Appropriate voting thresholds

4. Changes in Partners and Partnership

Changes in Partnership: Admission of a Partner



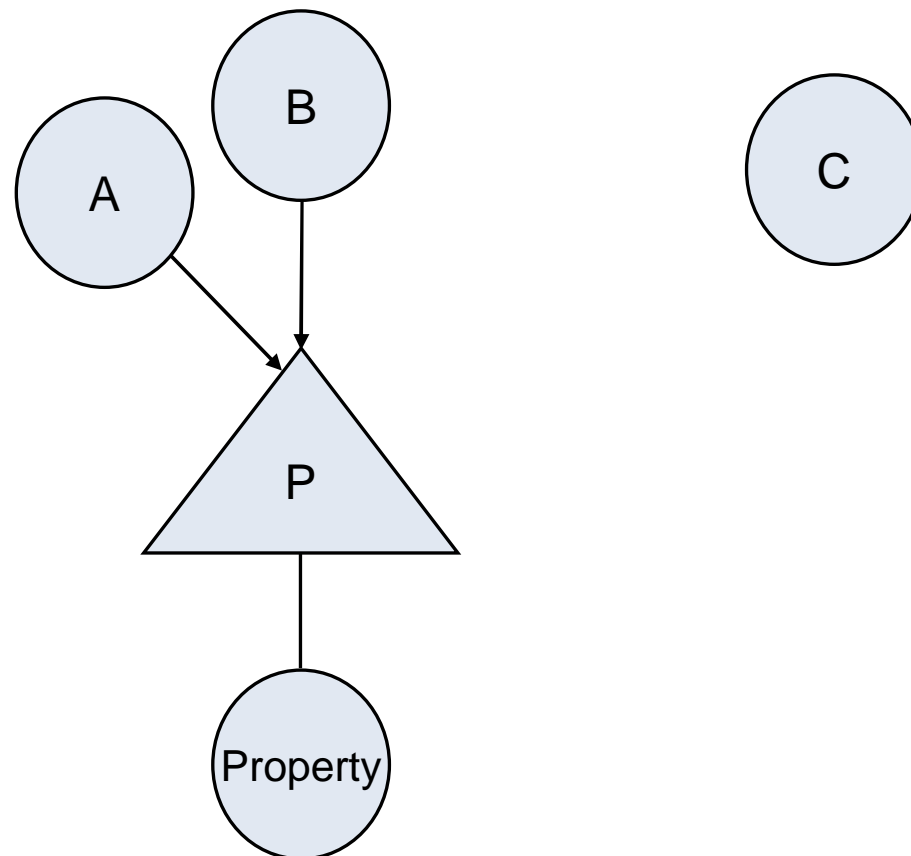
Changes in Partnership: Admission of a Partner

- Statutory requirement
 - admission of a new partner requires approval of all existing partners (ONPA, s.24)
- Partnership Agreement can provide for alternate approval requirements for introduction of new partners
- Absent an express agreement, the inference is that new partners will have the same rights and obligations of existing partners
- Ensure that changes in the composition of the partnership do not create a new partnership/dissolve existing partnership
- Required contribution/dilutive effects

Changes in Partnership: Admission of a Partner

- Partnership Agreement Terms:
- Approval requirements
 - "...no new partners are to be admitted except upon the affirmative vote of at least two-thirds of the existing partners..."
- Eligibility of new partners
 - consider setting out any required qualifications of new partners
- Accession
 - how will the new partner agree to the terms of partnership
- Required contribution
- Participation Rights
- Liability
 - Prior to admission
 - Following admission
- Management Role
- Integration Process
- No dissolution of the Partnership

Changes in Partnership: Removal of a Partner



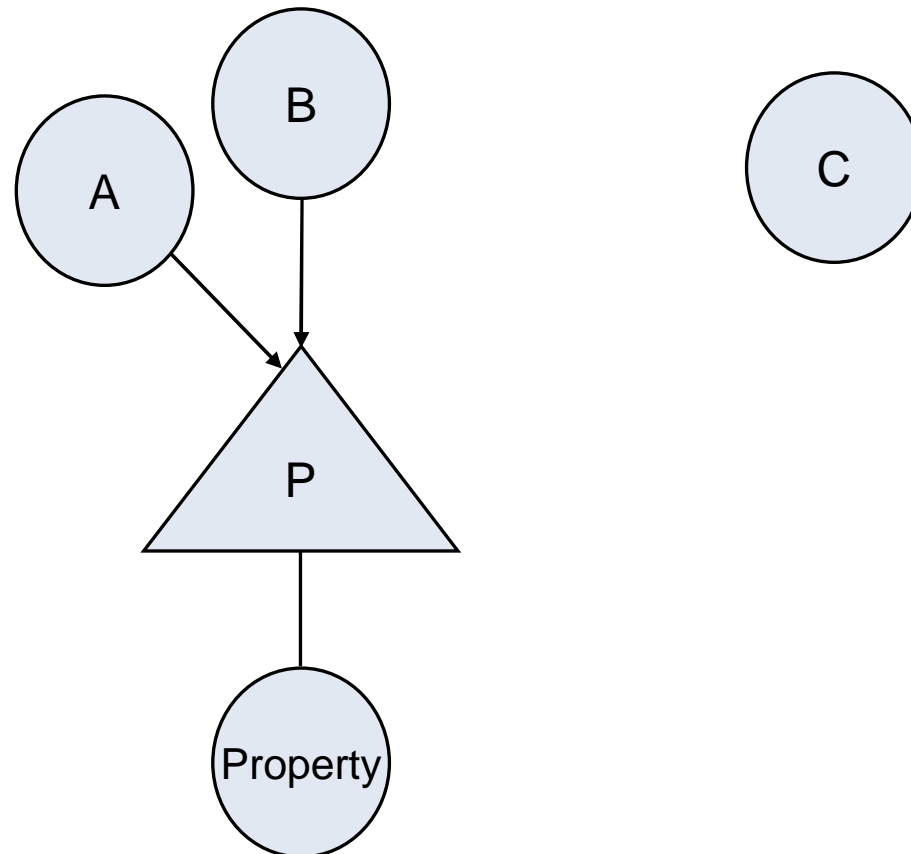
Changes in Partnership: Removal of a Partner

- No majority of the partners can expel any partner unless a power to do so has been conferred by an agreement between the partners (ONPA, s. 25)
- Expulsion power must be specified in the partnership agreement
 - Otherwise expelled partner must agree
 - Alternative: dissolve the partnership?
- Good faith
- Expulsion on bankruptcy

Changes in Partnership: Removal of a Partner

- Partnership Agreement Terms:
- Specify the grounds for removal
 - breach of partnership agreement
 - bankruptcy/insolvency
 - misconduct
 - criminal offence
- Nature and Form of Notice
- Effective Date of Removal
- Rights of the expelled Partner
- Entitlements of the expelled Partner

Changes in Partnership: Withdrawal/Retirement of a Partner



Changes in Partnership: Withdrawal/Retirement of a Partner

- Partnership Agreement should provide for withdrawal from the partnership
 - Otherwise, the consequence could be dissolution
- Voluntary withdrawal vs. forced withdrawal
- Temporary withdrawal

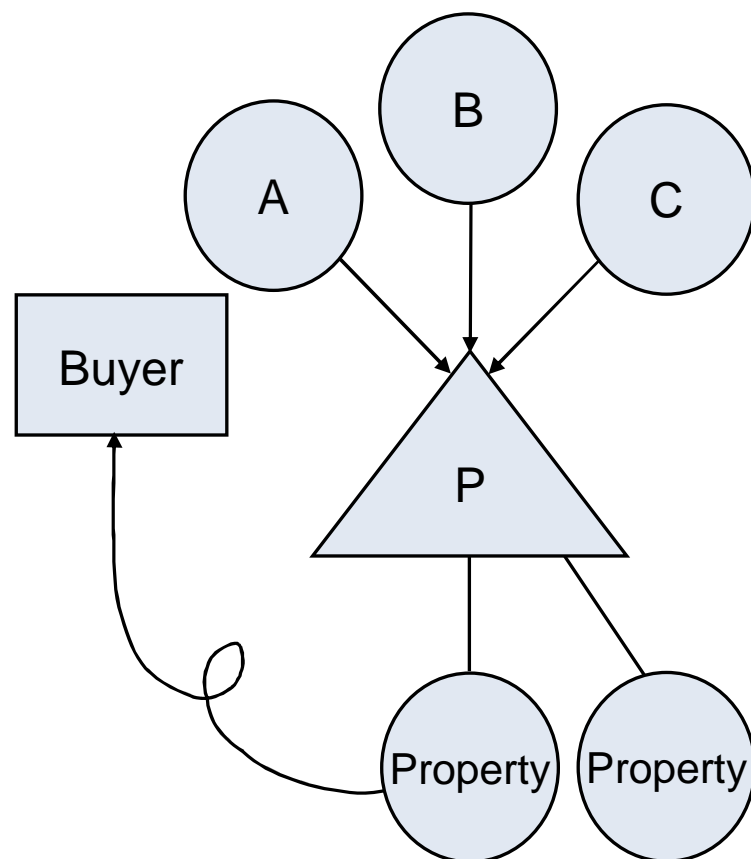
Changes in Partnership: Withdrawal/Retirement of a Partner

- Partnership Agreement Terms:
- Voluntary Withdrawal:
 - Notice
 - Withdrawal of assets/payment obligations
 - Rights of the withdrawing partner
 - Non-competition covenants
 - Process of withdrawal
- Forced Withdrawal:
 - Retirement
 - Disability
 - Unauthorized liability
 - Post-withdrawal obligations of remaining partners
 - Post-withdrawal obligations of withdrawing partners
 - Process of withdrawal

Changes in Partnership: Death/Disability of a Partner

- Unless the partnership agreement provides otherwise, a partnership is dissolved by the death of a partner (ON PA, s.33)
- Partnership is personal – rights do not transfer to successors, heirs or executors
- Temporary Absence and Disability
- Partnership Agreement Terms:
 - death/disability does not dissolve the partnership
 - obligations of remaining partners
 - entitlement of withdrawing partners

Sale of Property by Partnership



Changes in Partnership: Sale of Partnership Property

- Assumption: Asset is “partnership property”
- Governance Issue
 - approval requirements
 - process
- Registration/transfer of registration
 - registration in the name of a partner
 - registration in the name of the partnership
- Form of transfer

Changes in Partnership: Sale of Partnership Property

- Partnership Agreement Terms
- Approval requirements
- Process
- Use of proceeds
- Co-operation of partners
 - transfer of registration
 - form of transfer documentation

Changes in Partnership: Sale of Property – Tax Issues

- Partnership computes income / loss as if it were a taxable entity
- Allocation of tax liability between partners
- Flexibility to structure allocations appropriately (i.e., allocate gains attributable to prior tax-deferred “rollover” by a partner to the same partner)
- Adjustments to partners’ ACB

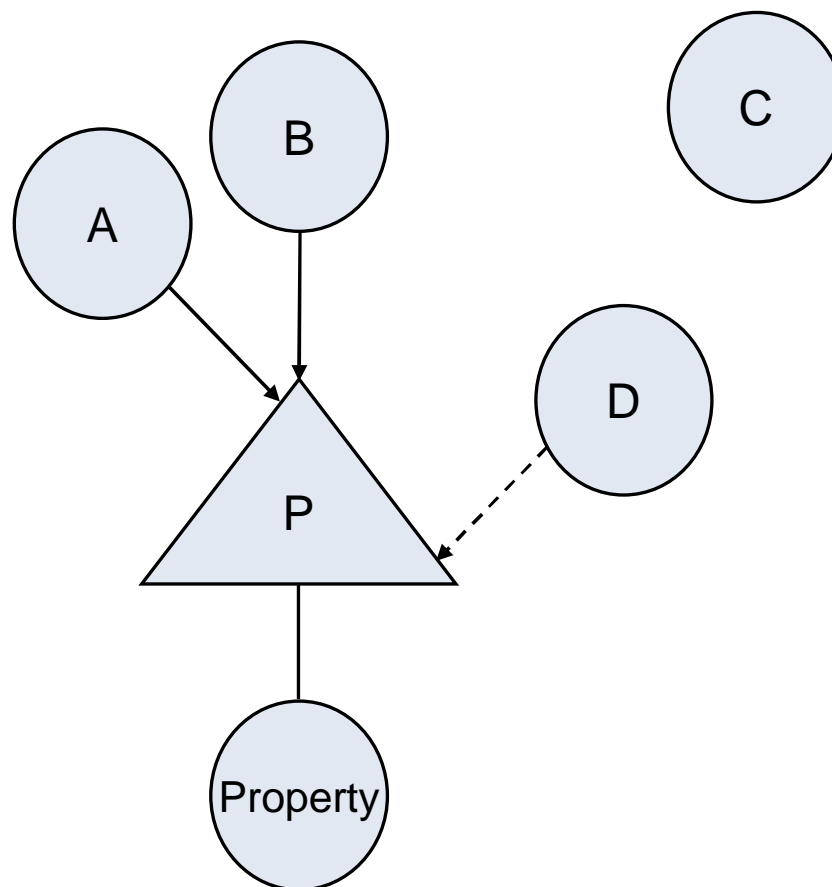
Changes in Partnership: Sale of Property – Tax Issues

- Gain or loss / ACB issues
 - Timing of sale and determination of ACB becomes very relevant
- 116 for non-resident partners if partnership interest constitutes “taxable Canadian property” (“TCP”)
 - Real property test
 - For rules were more restrictive (if partnership carried on a business in Canada then partnership interest was TCP)
 - Traps!

Changes in Partnership: Tax Issues - ACB “Bump” Transactions

- Sale of assets sometimes more tax-efficient if structured as sale of partnership interest
- Transfer “sale” assets to partnership on tax-deferred basis followed by sale of partnership

Sale of Partnership Interest



Changes in Partnership: Sale of Partnership Interests

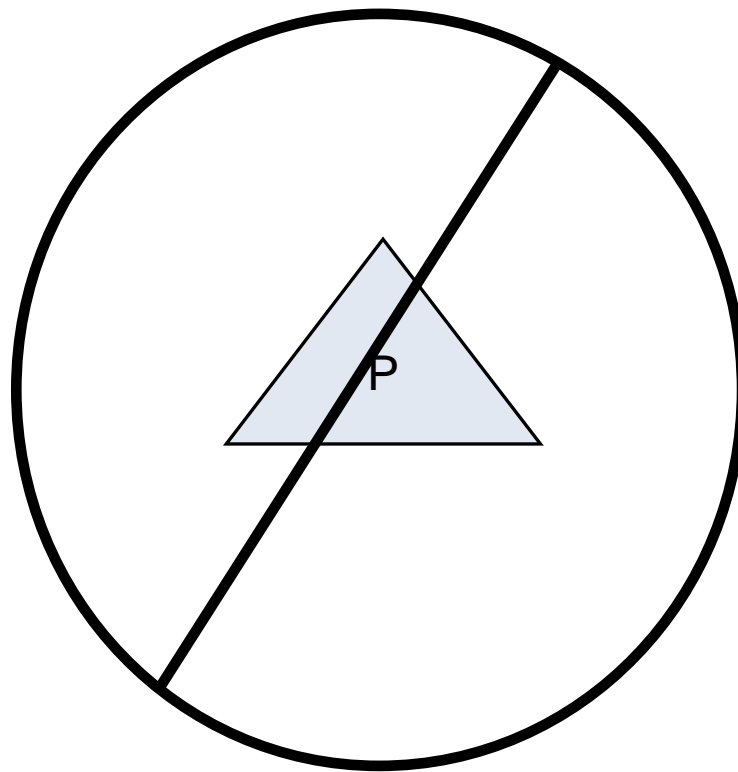
- Partnership relationship is personal to the partners
- Is an interest in a partnership different from any other asset?
- Right to be involved in administration vs. right to receive share of profits
- *Securities Transfer Act, 2006*

Changes in Partnership: Sale of Partnership Interests

- Partnership Agreement Terms
- Permitted transfers
- Assignee obligations
 - bound by partnership terms
 - conform to partner admission process
- Right of first refusal/offer
- Shotgun
- *Securities Transfer Act, 2006*

5. Dissolution/Termination of the Partnership Relationship/Bankruptcy

Termination / Dissolution of Partnership



Dissolution

- Expiry of a fixed term
- Completion of a specific undertaking
- Death or insolvency of a partner
- Charge over a partner's share of partnership property
- Unlawful to continue business
- Court order
- Dissolution vs. Expulsion

Dissolution: Partnership Agreement

- Only the provision dealing with “illegality” does not provide for an agreement between the partners to avoid automatic dissolution
- Considerations:
 - Fixed term
 - Single matter/undertaking
 - Notice of dissolution/notice of withdrawal
 - Death
 - Incapacity
 - Insolvency
 - Operating Loss

Dissolution: Consequences

- Timing
- Liability
- Capital
- Distribution of assets (cash and non-cash)
- Shortfall/surplus
- Post-dissolution obligations

Dissolution: Process

- Maximize assets
- Satisfy obligations
- Minimize costs of dissolution

Dissolution: Tax Issues

- Taxable wind-up (ITA 98(2))
 - Tax triggered on distribution of partnership property
- Tax-deferred wind-up (ITA 98(3))
 - Must be a “Canadian partnership”
 - All partnership property must be distributed pro rata among partners...each former partner must hold a ratable, undivided interest in each property
 - Partitioning of property may be possible (ITA 248(21))
 - Election required
- Termination through corporate conversion (ITA 85(2) and (3))
- Termination through conversion to sole proprietorship (ITA 98(5))

Bankruptcy of Partners/Partnership

- Joint and separate property
- Bankruptcy of the partnership
- Bankruptcy of a partner
- Separate creditors



Thank you. Questions?

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