



Partnerships: what, how and when

Corporate Update

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What is a partnership?

A partnership is a form of business arrangement consisting of two or more persons jointly carrying on business in order to achieve profit. A partnership allows its partners to pool resources and distribute risk to better achieve their mutual interests.

The term “partnership” is often used loosely in everyday language in situations where, from a legal perspective, there is no partnership. For example, a business relationship involving a collaboration between two persons may be commonly described as a partnership, when in fact it is a vendor-customer or joint venture relationship. In order to avoid unintended consequences by entering into a partnership, or improperly describing a business relationship as a partnership, it is important to understand what partnerships are, how they work and when you can use them.

In Canada, partnerships are governed by the laws of the province where they are formed. Generally, the regulations applicable to partnerships are not as stringent and extensive as those applicable to corporations, and partners have a great deal of flexibility in deciding how they want to set up and run their partnership. Provincial laws typically contain default provisions relating to the structure and management of a partnership, and partners can agree to modify these provisions to suit their requirements. Although by law the partners do not need to enter into a partnership agreement in order to form a partnership, a comprehensive partnership agreement is critical to the smooth functioning of any partnership. We have discussed partnership agreements in greater detail in a

separate article Partnership Agreements: A Primer.

Legal status

Although partnerships are legally recognized, partnership firms are not legal persons, unlike corporations. Therefore, while a partnership firm may be sued in its own name, the firm's partners are liable for the debts and obligations of the partnership firm. However, the extent of such liability will vary depending on the type of partnership and the manner in which the partners have structured the partnership.

Relationship of partners

In a partnership, each partner is an agent of the partnership firm as well as each other partner. In other words, the actions of a partner are binding on every other partner, whether or not they knew or approved of them. For example, if a partner borrows money from a lender for the partnership, all of the partners are responsible for repaying the loan. The only exceptions are where the partner does something that is not authorized by the partnership agreement, and the third party he or she is dealing with knows that the partner does not have the authority.

Each partner is required to act in good faith with the other partners. Each partner must act honestly and in the best interest of the partnership. As an example, if a partner becomes aware of a business opportunity that could benefit the partnership, he or she cannot take advantage of the opportunity himself or herself, and must bring it to the attention of the partnership.

Profit, loss and taxation

Under the *Income Tax Act* (Canada), partnerships are not taxable persons. However, according to the accounting rules, the income or loss of a partnership is calculated as if the partnership were a separate legal entity. A partner's share of the partnership's net income is then included for the purposes of determining his or her income / loss for a taxation period. A partner's share in the losses of the partnership can also be included for the purposes of determining the partner's income / loss in certain circumstances.

Partners are entitled to share in the profits of the partnership and contribute to the losses of the partnership in equal proportions, unless the partnership agreement has a different allocation. Often, partnership firms will distribute profit in proportion to the capital contributed by each partner to the firm, or the amount of time dedicated to the partnership business by each partner.

Types of Partnerships

Provincial statutes in Canada recognize three types of partnerships:

1. general partnerships;
2. limited partnerships; and
3. limited liability partnerships.

This article focuses on general partnerships and limited partnerships. Limited liability partnerships are special partnerships that are only permitted for certain professions, including lawyers and accountants.

General Partnership

A general partnership is the simplest and most common form of a partnership. A general partnership is formed when two or more persons carry on business with a view to profit. It is not necessary to make a filing or a registration, or enter into an agreement to form a partnership, and a partnership can be said to exist simply on the basis of the conduct of the partners. Legislation in certain provinces requires partnerships engaged in designated businesses to file a declaration of partnership with the designated authority under such legislation (typically the registrar of corporations).

Liability of Partners

Each partner of a partnership firm is jointly liable with the other partners for all of the debts and obligations of the

partnership incurred while such person was a partner. The liability of partners in a general partnership is unlimited. Thus, a third party may seek to enforce the performance of a partnership's obligations, or the repayment of a partnership's debt against any one or more of the partners, irrespective of which partner was responsible for the incurrence of the obligation or debt, and each partner is liable for the entire obligation or the repayment of the entire sum. However, as among themselves, partners may apportion their liability as partners by way of a partnership agreement, or seek indemnification from the other partners.

Partnership Property

Partnership property is all the property and rights and interests in property originally brought into the partnership, or acquired by the partnership in the course of the business of the partnership. Partnership property should be held and applied by the partners exclusively for the purposes of the partnership, unless otherwise provided for in the partnership agreement. Therefore, it is important to separate property held by partners in their personal capacity from the firm's property.

Use of General Partnerships

Owing to the unlimited liability of partners for the debts and obligations of the partnership, general partnerships are used only in certain, narrow circumstances, usually dictated by tax considerations. For example, when each of the partners wants or needs to be directly involved in the operation of the partnership's business, they can enter into a general partnership.

Limited Partnership

A limited partnership ("LP") is formed when a certificate or declaration of limited partnership is filed with and registered by the designated authority (usually the provincial registrar of corporations). An LP allows the liability of some of the partners to be limited, by having two categories of partners:

- (i) a general partner, who is responsible for the management of the LP and its business; and
- (ii) a limited partner, who is responsible for contributing capital to the partnership, but cannot be involved in the management.

The certificate or declaration of partnership usually describes the type of business to be undertaken by the partnership, the amount of capital and any additional contributions to be made by each limited partner, the term of the partnership, allocation of profits or compensation among limited partners, the rights and obligations of the general partner and provisions relating to the admission and withdrawal of limited partners. It is standard practice for the general partner and the limited partners to enter into a comprehensive limited partnership agreement which addresses the matters required to be included in the certificate or declaration of limited partnership, among other matters.

Liability of Partners

The liability of limited partners in an LP is limited to the amount of capital they have contributed, or agreed to contribute to the partnership. Limited partners are not permitted to be involved in the management or the business of the LP. In the event a limited partner becomes involved or participates in the management of the LP or its business, it is deemed to no longer be a limited partner and loses its limited liability status.

The general partner is responsible for managing the LP and its business. A general partner has all of the rights and is subject to all of the obligations and liabilities of a partner in a partnership, and as such has unlimited liability for the obligations and debts of the LP. A general partner acts as the agent of the LP and the limited partners for the purposes of the business of the LP, and enters into contracts with third parties on behalf of the LP. A general partner cannot take certain actions without the consent of all of the limited partners, including taking any action contrary to the certificate or declaration of partnership, or taking any action that makes it impossible for the LP to conduct its business in the ordinary course. Since a general partner has unlimited liability, it is a common practice for the general partner to be a corporation.

Partnership Property

All of the property of an LP is held by the general partner for and on behalf of the LP. Subject to any restrictions in the certificate or declaration of partnership or the limited partnership agreement, a general partner has the absolute authority to apply and use such property in relation to the business of the partnership.

Use of LPs

LPs are a popular form of business arrangement and in certain circumstances, the use of an LP can prove to be more advantageous than a corporation. An LP allows limited partners to limit their liability in the same way that the liability of the shareholders of a corporation is limited. However, unlike a corporation, the LP is not a separate legal person. As such, a limited partner's share of the profit or losses of the LP can be included in its income or loss. Further, an LP has fewer reporting and compliance obligations under applicable legislation, which provides enhanced levels of privacy and flexibility.

Conclusion

Depending on your specific circumstances and business requirements, a partnership can prove to be an ideal platform to conduct business. It affords flexibility, affordability and a certain degree of privacy. However, before entering into a partnership, you should consult with your accountant / tax advisor and legal counsel to ensure that a partnership works for you, and the benefits outweigh the potential risks. If you do decide to proceed with a partnership, you should consider entering into a comprehensive partnership agreement with your partners to document the rights, obligations and liabilities of the partners. For further information on partnership agreements, please see our article Partnership Agreements: A Primer.

This article provides only general information about legal issues and developments, and is not intended to provide specific legal advice. Please see our [disclaimer](#) for more details.

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