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Limited Partnerships: Investment Opportunities for Financing R & D in Canada

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Introduction

Canada's future economic development will depend largely on our success in developing a vigorous technology industry in this country. The federal government is committed to increasing national research and development (R&D) activity and has established R&D targets for the public and private sectors. To date, the federal government has exceeded the expenditure target which it set for itself. Research intensive industries have been increasing their R&D investments substantially with the assistance of federal programs and R&D tax incentives. Over the next decade, the opportunity exists for Canadians to invest in our technological future and enjoy some of the enormous potential rewards.

This booklet describes how individuals and corporations can invest in R&D ventures through a limited partnership and use federal tax incentives to improve the risk/reward ratio of such an investment. At the same time, the limited partnership approach may be used by entrepreneurs to raise capital to do more scientific research in Canada.

This brief description does not attempt to cover all aspects of Canadian federal and provincial tax laws as they affect partnerships. In certain provinces income tax legislation is not the same as the Income Tax Act of Canada. Thus, limited partners should seek legal and professional tax advice on both the provincial and federal income tax consequences of participating in such a partnership.

Definition of a Partnership

The terms 'partnership' and 'partnership interest' are defined under provincial laws rather than in the Federal Income Tax Act.

Various provincial partnership Acts define a partnership as the relationship which exists between persons (i.e. individuals or corporate entities) carrying on a business in common with a view to profit. The relationship between members of an incorporated company is not considered a partnership. Whether a partnership exists or not is a legal question which must be determined by applying the principles of law to the facts and circumstances in each case.

General Description of a Limited Partnership

A limited partnership has two classifications of partners. First, there are one or more general partners who conduct the business and have joint and several liability for the financial undertakings of the partnership. Second, there are limited partners who contribute capital and own an interest in the partnership but who are prohibited from participating in the management of the business. Limited partners are liable to creditors of the partnership only to the extent of capital contributed. This limited liability may also restrict potential tax incentives to the limited partner (see IT-138R of Revenue Canada–Taxation).

"The partnership itself is not subject to federal income taxes. However, in the case of an R&D limited partnership, the net income or loss available to the partnership after claiming the 100% deduction, (see Appendix I) would flow through to the partners in amounts proportional to their capital contributions or in accordance with their partnership agreement. In addition, the investment tax credit for R&D may be taken by members of the partnership.

The limited partner may be an individual, a corporation or another partnership. Similarly, the general partner may be an individual, a corporation or a partnership who may carry out the R&D itself or who may contract the R&D to other parties.

Limited Partnerships for R&D in Canada

Limited partnership arrangements have been used in Canada to finance risky ventures that require significant amounts of up-front capital (e.g. oil and gas exploration and Canadian certified feature films).

R&D typically requires large up-front capital investment and realizes little or no return in the early years.

Although the tax incentives for a member of a limited partnership can be significant, capital is nevertheless at risk. The mechanism of the limited partnership seeks to alter the risk/return trade-off by using the federal R&D tax incentives. This action reduces the amount the partner effectively has at risk and at the same time, increases the potential return on the capital invested. However, each venture must be assessed on its merits as an investment opportunity and on the member's ability to support a possible loss, regardless of the tax incentives.

There are two basic approaches to forming an R&D limited partnership. The performer of the R&D can be either a general partner of the limited partnership or can act as a contractor to the limited partnership to carry out a specific R&D project.

In the first case, the performer, as a general partner can attract prospective members by presenting a prospectus detailing the business plan and highlighting some Canadian income tax aspects such as a general description of the limited partnership and the R&D tax incentives for limited partners. In addition, the prospectus should explain how limited partners can earn a return on their investment in the R&D. For example, the partnership could receive a percentage of the sales price of each product produced using the technology developed under the agreement.

The second basic approach to forming a limited partnership is for an entrepreneur, a financial institution or a venture capitalist to act as a general partner who develops the prospectus and who also arranges the contract with an R&D performer to carry out a specific R&D project. The limited partners would be in a position similar to that described earlier. The general partner would provide management experience, marketing know-how or financial expertise for the limited partners and R&D performer. The performer would normally do R&D on a contract basis for the limited partnership. The agreement between the general partner and the limited partners as well as the contract between the R&D performer and the limited partnership would detail the obligations and benefits for all parties.

In both the basic approaches the R&D performing company does not have to give up any equity by entering into the agreement. These basic approaches can be modified to suit the circumstances.

Conclusion

Under certain circumstances, forming an R&D limited partnership is more attractive than financing R&D projects in Canada through equity or debt. Not only can investors enjoy the rewards flowing from R&D and innovation but they can do so at a reduced cost due to the tax incentives which offset some of the risks involved. This booklet does not explain all the technical details of R&D limited partnerships, but presents a general overview. Professional advice is required when making partnership arrangements.

In addition, Revenue Canada-Taxation publishes a series of Interpretation Bulletins. The following refer specifically to R&D and partnerships:

IT90	What is a Partnership?
IT138R	Computation and Flow-through of Partnership Income
1T151R2	Scientific Research Expenditures and Allowances
1T439	The Meaning of Scientific Research

For more information on the above bulletins please contact:

Corporate Rulings Directorate
Revenue Canada–Taxation
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For additional copies or more information on this document, please contact:

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Appendix I
Tax Measures for R&D

R&D tax incentives are as follows:

The 100 Percent Deduction

A taxpayer in Canada (i.e. an individual or a taxable corporation) is allowed to deduct all qualifying current and capital R&D expenses in determining taxable income for the year in which these expenses were incurred or in any subsequent year. Taxpayers are not required to amortize the write-off of their capital R&D expenditures over a period of years, as they are with other classes of capital expenditures.

This measure has been in effect since 1944, and has no expiry date. The law is found in Section 37 of the Income Tax Act, while the definition of eligible activities which qualify as "scientific research" is found in the accompanying Regulation 2900.

The 50 Percent Additional Allowance

Corporations carrying on business in Canada may deduct an additional allowance for scientific research on those qualifying current and capital expenditures for R&D in excess of the level of expenditures over a three year moving average. The allowance is 50 percent of the firm's increase in R&D expenditures as outlined above.

It is the position of Revenue Canada–Taxation that the additional allowance is *not* available to partnerships, including those whose members are composed solely of corporations.

The measure applies for a ten year period, for the years 1978 to 1987 inclusive. The law is found in Section 37.1 of the Income Tax Act. In addition, Regulation 2901 of the Income Tax Act describes certain types of expenditures which are disallowed as R&D under this measure.

The Investment Tax Credit for R&D

In addition to other R&D incentives, taxpayers in Canada are allowed to claim a credit against their federal taxes payable (i.e. a reduction in their federal taxes) in an amount equal to their qualified current and capital expenditures on R&D, times a certain percentage rate.

The November 1978 Federal Budget established these rates at (a) 25 percent for eligible small business corporations; (b) 20 percent for taxpayers performing R&D in the Atlantic provinces or the Gaspé; or (c) 10 percent for taxpayers performing R&D elsewhere in Canada.

The law is found in Sections 127(9), 127(10.1), and 127(11.1) of the Income Tax Act. As with the 50 percent Additional Allowance for R&D, certain types of expenditures are disallowed under this measure. These are described in Regulation 2902.