



### **What is a Limited Partnership (LP):**

A 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 pre-determined way. It is a well thought out, provincially regulated legal vehicle to raise capital for a venture without the expensive overhead of a public company. Each LP has one general partner (GP) and one or more limited partners.

An LP is like a marriage of multiple parties. Unlike a real marriage, it takes a sense of structure if 34 people marry. One party has the expertise for a certain business venture, in our case, multi-family residential real estate in North-America – the GP. The other parties have a desire to invest some of their capital for significant returns, limited risks and potential tax savings. The GP usually executes all activities of the business venture, reports regularly to the investors and shares the profits with the partners in a pre-determined fashion.

In essence, **the GP-LP relationship is like a trustee-trust relationship**: the trust (LP) holds all the assets, but the trustee (GP) on behalf of the trust (LP) manages the assets of the trust (LP).

The GP in our latest syndication is called PRISM A Inc (Prestigious InveStment & Management A Inc.).

The benefits to the investors / limited partners are

- a) limited risk – to the amount invested, even in case of a major disaster or law suit
- b) clear delineation of responsibility – one party is the general partner which does all

- c) allocation of 100% of losses for potential tax savings (usually in early years due to start-up costs and depreciation)
- d) clearly defined time line (up to 5 years in our case)
- e) possibility to sell units to later partners at annually set prices (usually higher)
- f) existing and well tested legal framework, with oversight by provincially appointed regulators
- g) annual reporting
- h) regular distributions, likely quarterly

Unlike a publicly traded or private company (often with a joint venture contract), capital gains, losses and/or income are flown through to the LP Unit holders in a pre-determined fashion, as described in the next section.

### **Tax Implications of a LP Investment - Distributions**

The LP agreement that you signed (or intend to sign) provides that income and net taxable capital gains for purposes of the Tax Act will be allocated to LP Unit holders in the same proportion as distributions received by Unit holders.

Distributions may consist of the following for income tax purposes for which T5013 partnership income statements are issued, usually in the latter half of March for the previous tax year

- a) distributions that are currently taxable. This portion of distributions for income tax purposes will be treated as regular taxable income (and not treated as dividends or capital gains) to each Unit holder

- b) distributions that are treated as a dividend received from a Canadian or US subsidiary corporation. As such, it will be subject to a preferential tax treatment that all dividends from Canadian corporations receive (subject to the dividend tax credit)
- c) distributions that represent your portion of capital gains allocated to you relating to gain on the sale of a property in the year, if any.

Please note that of the portion reported as capital gains on your tax return, only 50% of this is included in the calculation of your taxable income. The non-taxable portion of the capital gain is not deducted from the adjusted cost base of your Units.

- d) distributions that are not currently taxable and will be treated for income tax purposes as a return of capital

Accordingly, this currently non-taxable portion will reduce the adjusted cost base of the Units owned by each LP Unit holder. If, after deducting the return of capital portion, your adjusted cost base of your Units is a positive amount, no portion of the return of capital will be taxable. If, however, after deducting the return of capital, your adjusted cost base of your Units is a negative amount, you will realize a capital gain equal to the negative amount and your resultant adjusted cost base of your Units will be nil.

LP Unit holders should consult their tax advisors with respect to any questions they may have concerning tax matters.

### **Tax Implications of a LP Investment - EXAMPLE ONLY**

Let's use an example of an investment of \$100,000 which represents 5% of an 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/years (7% CAP)

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

Initially, we flow out 100% or \$100,000 to investors, or 5% annually, or a quarter thereof quarterly. After you have received all your initial money back, usually after a few years – after we have sold some and/or have re-financed the rest based on a higher value, we take 40% of the upside as our share, and the remaining 60% is flown to investors until the LP is closed or you decide to exit.

In addition, there may be additional distributions as we may have surplus cash in the corporation as possibly not all received investments have been invested into cash-flow properties. Thus, your distribution may be higher.

Thus, on a \$100,000 investment you get a cheque for (or four cheques totalling) \$5,000 – which is either a return of capital (non-taxable) or taxable income, a dividend or capital gains (in addition to your other income / gains that you may have).

You also have the option to re-invest the cash in additional units (DRIP: Distribution Re-Investment Plan)

In addition to this cash-flow you may also get a loss allocation. Unlike the income, the losses get allocated 100% to LP Unit holders, as per the offering memorandum that you signed or intend to sign. In our example, for your \$100,000 investment you get 5% of the losses the LP generates.

Why is there a loss if the company generates both cash-flow and an operating profit? Because the building gets depreciated by 4%/year. Let's assume the buildings are worth \$5,000,000 and the land is

worth \$1,000,000. Land does not get depreciated, just buildings. Thus, the annual building depreciation is 4% of \$5,000,000 or \$200,000 (if held for the entire year, less in year one). Thus, our income/loss is calculated as follows: \$100,000 cash flow plus \$100,000 in principal reduction minus \$200,000 depreciation, i.e. we have no loss.

Thus, you may get non-taxable cash-flow and a loss allocation. Frequently, these potential losses are higher in year one as the cash-flow is not yet as strong and the expenses higher due to upstart cost and building renovations.

We may hold US assets, usually through a subsidiary US C corporation, which in turn will hold each building through a LLC (limited liability corporation). This US corporation will pay dividends to Canadian LP unit holders, if income or profits are created due to cash-flow or gains from sale of US based assets. It is beyond the scope of this introductory document to advise on US tax issues such as withholding taxes or dividends. We have hired BDO Dunwoody as our tax advisor to ensure proper filings in the US and in Canada, to appropriately reduce US and Canadian taxes, and to ensure that Canadian LP unit holders do not have to file US income taxes or US tax returns.

#### **Sub-Sequent Rounds / Re-valuation of LP Units**

In LP1, we started with a \$5000/LP unit value in 2005. In early 2006 we re-valued the units to \$6000 since the assets we purchased had increased in value. This LP, as well as its three successor LPs, are now closed and LP1 units should be worth around \$10,500 or more (see track record pages). We send out quarterly statements with an estimated NAV (net asset valuation) to show approx. unit value if buildings were sold, since the GAAP based accounting statements capture book values only and not market values of buildings. This is common practice in Europe and may be introduced into Canadian REIT legislation in the next few years as well. This unit or NAV revaluation may happen also

in PRISM A: the later you invest the more money you may have to pay per unit. Initial price is \$5000 per unit and may be adjusted at the GPs discretion at any time.

#### **Liquidity Events**

Besides cash-flow from operations there may be major liquidity events. What is a major liquidity event: it is either a sale of a building or a re-financing of a building. If augmented by other cash-flow rich projects, possibly some condo conversion candidates, regular quarterly cash-flow is a very realistic and reliable target !

Note: This is an example only, and does not constitute tax or legal advice. Tax advice can only be given by an authorized professional such as a chartered accountant, lawyer, certified financial planner or like authority. Numbers, returns or profits are not guaranteed and are an example only.

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For more information, or a detailed offering memorandum, please contact:

Prestigious Investment & Management Group  
c/o Mike or Scotty or Thomas  
#912, 743 Railway Ave.  
Canmore, AB T1W 1P2 – CANADA  
T: 403-678-3330 F: 403-770-8885  
E: investor@prestprop.com

**[www.prestprop.com](http://www.prestprop.com)**

