RightRisk™

Risk Concepts

General Partnership

Historically, farms and ranches were operated as sole proprietorships. The land, machinery, livestock, and other assets were owned and used by an individual or couple. Likewise, the individual (or husband and wife) farmer/rancher was personally responsible for all debts and financial obligations owed by the business. The farmer or rancher was the business, and the business was the farmer or rancher.

There are a number of organizational structures that may better meet the needs of today's farm/ranch business. A few of the more common business entities used by farmers and ranchers include sole proprietorship, general partnership, limited partnership, limited liability company (LLC), and corporation. Each U.S. state recognizes most legal entities, while the U.S. Internal Revenue Code recognizes all business forms except LLCs. Each organizational structure has its strengths and weaknesses. Before a decision is made as to the legal entity under which to operate, a person – or person and his or her family and other partners – need to determine the goals of and needs for the business and its assets.

A general partnership is an association of two or more people who agree to carry on a business as co-owners for a profit. The partnership form of enterprise has been around for many years and is familiar to most legal, accounting, and other professionals. As such, there is a high familiarity factor and there are a number of resources which can be relied upon for forms and research.

The general partnership is a very flexible form of enterprise. State partnership statutes provide default rules pertaining to management rights and the calculation of each partner's share of profits and losses. However, the partners in a partnership agreement are generally free to change these default provisions by agreement. For example, absent agreement to the contrary, all partners have equal management authority and are entitled to share equally in the profits and losses of the enterprise. However, it is not at all unusual to see a general partnership with a managing partner or executive committee with full management powers and with allocations of profit and loss among the partners that are not equal.

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Most states have adopted two federal statutes – the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) – which provide significant consistency across states. However, case law interpreting the rules created by the Acts creates some inconsistencies in application and rules of partnerships. There is one significant difference between partnerships formed under the two statutes. Under RUPA, the general partnership is explicitly recognized as an entity distinct from the partners. In the event of litigation, the partnership can sue and be sued by others. Under UPA, the individual partners must bring any legal action or be sued in their own names.

Formation

A general partnership is an association of two or more persons who have agreed to carry on a business as co-owners for a profit. No particular formalities are required to form a general partnership. There is no filing requirement and the "agreement" to form a partnership need not be in writing and need not contain any particular language. In fact, it is possible to form a "partnership" without ever using the words "partner" or "partnership," and RUPA expressly states that intent to form a "partnership" as such is not required. Further, the UPA and RUPA provide that joint ownership of property (whether as a joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership) does not of itself establish a partnership. In addition, both uniform acts specify that the sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

On the other hand, both statutes also state than an agreement to share profits creates a presumption that a general partnership exists. The presumption can be rebutted if it is proven that the profits were paid as interest on a debt, as compensation to an employee, or in other enumerated situations. However, even though the presumption can be rebutted, sharing of profits is a risky proposition unless a partnership relationship is intended. The statutory rules create a very fine line, and the case law interpreting these rules is neither completely consistent nor predictable.

Ideally, a partnership should be documented by a written agreement. The agreement will serve as a written record of the parties' actual agreement in the event of future disputes, imperfect memories, or the death of a partner. It will minimize the risk that the partners will be surprised by any default rules in existing partnership statutes. Also, a written partnership agreement will enhance communications between the partners and their families.

Operational Attributes

The management rights of partners in a general partnership should be described in the partnership agreement. Absent such an agreement, it is assumed that all partners have the authority to obligate the partnership within the normal course of business.

The partnership agreement should specify contributions made by each partner and how profits or losses are to be divided. Absent any agreement by the partners to the contrary, the UPA and RUPA stipulate that all partners are to share equally in the profits and losses of the business.

The partners in a general partnership are deemed to have a "capital account" equal to the value of all contributions to the partnership. It is the value of each partner's capital account – share of ownership – that typically determines the manner in which profits and losses are shared.

A partnership can benefit by including the fiduciary responsibilities and behaviors of the partners in the partnership agreement. While UPA does not expressly define the extent of a partner's fiduciary obligations, case law generally imposes broad fiduciary obligations on all partners. Although the RUPA expressly incorporates principles of law and equity to partnerships, it presumes that partners have only two fiduciary duties: the duty of loyalty and the duty of care. The duty of loyalty is an obligation to account for property or anything of value derived by a partner conducting (or winding it up) partnership business, an obligation to avoid dealing with the partnership as an adverse party, and the obligation to refrain from competing with the partnership. A partner's duty of care to the partnership and the other partners in the conduct (and winding it up) of partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. Although it is not described as a fiduciary obligation, the RUPA does specify that a partner shall discharge his or her duties "consistently with the obligation of good faith and fair dealing".

Liability

One of the most significant drawbacks to a general partnership is that all partners have personal liability for all debts of the partnership. Under the UPA, all liability was generally joint, meaning that each partner is liable for his or her own debts or the partner's prorated share of the obligation. The RUPA and other statues in some states generally impose joint and several liability on all partners for partnership obligations. Joint and several liability means that any partners can be held liable for the full amount of the debt, even if other partners cannot be found or joined in the litigation.

Tax Attributes

There are no entity-level taxes imposed on partnerships. Each item of income and loss is passed through to the partners equally or in accordance with the partnership agreement. Further, the partnership agreement may stipulate that (1) partnership profits or losses are shared among the partners in the same manner; (2) profits may be shared differently from losses; and/or (3) particular items of tax income, gain, loss, deduction, or credit will be shared differently than overall partnership business profits and losses. Generally, if a tax related allocation is different from the owners' interest in the partnership, the "substantial economic effect" test must be used to determine the individual partner's tax consequences.

The Internal Revenue Code provides partners with considerable flexibility to structure their profit and loss sharing arrangement for tax purposes. A partnership agreement might provide that (1) partnership tax profits and losses be shared equally among partners; (2) taxable profits be shared different from taxable losses; and/or (3) particular items of tax income, gain, loss, deductions, or credits be shared differently than the overall partnership tax profits and losses. The default rule is that all partners are to share in the profits and losses of the business in accordance with each partner's interest in the partnership.

Partners are not allowed to receive remuneration for services rendered to their partnership. A partner may receive payments from a partnership provided the dollar amount of the payments are determined without regard to the partnership's income. These are called "guaranteed payments". A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding.

A partnership may file a special election with the I.R.S. to be taxed as a corporation. Such an election is made upon the formation of the partnership rather than made year-to-year. However, there are few advantages – given the current U.S. tax structure – for a partnership to elect corporate tax status.

Transfers of Ownership (Succession and Estate Planning)

A partner in a general partnership is generally not entitled to transfer all of the attributes of ownership to any other person, absent the unanimous consent of all other partners. The default rule under UPA and RUPA is that a partner can transfer his or her rights to profits and distributions but not any other rights traditionally vested in partners. The person receiving the economic rights would have only very limited rights and no ownership nor management rights.

Partners may admit new partners by unanimous consent or via any procedures provided in the partnership agreement. It is common to have partners pre-approve certain classes of transferees for admission to the partnership as partners, particularly family members of the original members.

Dissolution

Ending of a general partnership has three phases: dissolution, winding up, and termination. A partnership that has "dissolved" continues to exist for the purpose of "winding up" its business. "Termination" occurs when the winding up process is completed.

Dissolution begins when a partner voluntarily withdraws from the partnership (e.g. retirement or announces an intent to withdraw) or involuntarily (e.g. death, incapacity, or removal by the other partners). Under the UPA, a general partnership automatically begins dissolving when a partner ceases to be associated with the partnership unless the partnership agreement provides for it or the dissolution is wrongful (which means either that the partner's

withdrawal is in contravention of an express provision in the partnership agreement or that it occurred before the expiration of a definite term or the completion of a particular undertaking for which the partnership was formed). The revised statutes (RUPA) provide that either dissolution may be followed by winding up the business or the business may be continued and the withdrawing partner paid off.

Summary

A general partnership is an association of two or more people who agree to carry on a business as co-owners for a profit. It is well understood by and familiar to most legal, accounting, and other professionals. The flexibility of a general partnership gives it several advantages over other forms of business. Disadvantages include difficulties in transfer of ownership and exposure of partner personal assets to business liability.

A person wanting to start a business should first determine his or her risk preferences and both short and long term goals; second, seek appropriate professional caounsel from an attorney, accountant, and others; and finally, establish the business.

Resources

Part I: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.
Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises. Goforth, Carol R. An Agricultural Law Research Article. National Agricultural Law Center. July 2002.
Fact Sheets from the Internal Revenue Service and Secretary of State office in various states.

The information presented in this document is intended for educational purposes only. It should not be construed as providing legal, accounting, or other professional advice. People considering the establishment of a business enterprise should seek appropriate professional assistance.