



# Risk Concepts

## Limited Partnership

**H**istorically, 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 limited partnership is a partnership with at least one general partner and at least one limited partner. It can only be formed by filing (usually with the Secretary of State) a written document which names the partners. The biggest distinctions between general and limited partnerships have to do with management rights and limited liability of the limited partners. The Revised Uniform Limited Partnership Act (RULPA) established this business structure and provides the regulations for creating, operating, and dissolving limited partnerships.

### Formation

A limited partnership is formed by filing a certificate of limited partnership with appropriate state officials. The information required to be contained in a certificate of limited partnership is quite basic. However, unless the parties wish to abide by the default rules contained in the relevant statutes, much of what the partners agree to will be contained in a partnership agreement.

Some states do not require a written partnership agreement, but there are sound reasons for doing so (such as the ease of proof in the event of a future dispute).

Although the statutory requirements associated with the formation of limited partnerships do not appear to be particularly complex, persons who attempt to form a limited partnership but fail to follow the required statutory formalities run the risk that they will be found to have inadvertently created a general partnership, subject to all of the default rules of the UPA or the RUPA, whichever statute controls general partnerships in the subject jurisdiction.

## Operational Attributes

Management of a limited partnership is vested in the general partners. Limited partners do not have management authority.

The RULPA prohibits distributions that would render a limited partnership insolvent. Additionally, provided the limited partnership agreement does not stipulate otherwise, a general partner has the absolute right to withdraw from a limited partnership at any time but a limited partner is required to give a minimum of six months written notice to each general partner before withdrawing. Withdrawal of a general partner or a limited partner does not necessarily trigger dissolution.

The partners in a limited 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.

## Liability

Limited partners have a benefit not possessed by general partners – they do not have unlimited personal liability. If, however, a limited partner takes control of the business and a third party assumes (because of their actions) the partner is a general partner, the limited partner loses his or her limited liability to the third party.

The RULPA lists a set of activities that a limited partner may do without “participating in control” of the partnership and risk losing the protections of limited liability:

1. Being a contractor for or an agent of the limited partnership or of a general partner;
2. Consulting with and advising a general partner about the limited partnership’s affairs;
3. Guaranteeing specific partnership obligations;
4. Taking any action to bring or pursue a derivative action in the right of the limited partnership;
5. Requesting or attending a meeting of partners;
6. Proposing, approving, or disapproving on various specified matters that may be considered at a partnership meeting;
7. Winding up the limited partnership; or
8. Exercising any other right or power permitted to limited partners under RULPA.

Another way for a limited partner to have unlimited personal liability is to knowingly permit his/her name to be used in the name of the limited partnership. In such a case, the partner will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

A person may believe he or she is a limited partner when in fact he or she is not. This may occur because either no certificate of limited partnership was properly filed – therefore the limited partnership does not exist – or because the person was improperly omitted from the list of limited partners.

A person who makes a contribution to a business and “erroneously but in good faith” believes he or she has become a limited partner has two ways to reduce his or her liability. The person can file an appropriate certificate of limited partnership or a certificate of amendment. The person may also withdraw from future equity participation in the enterprise by executing and filing a certificate declaring such withdrawal with the appropriate state officials.

## Tax Attributes

Limited partnerships are among the entities that are entitled to elect whether to be taxed as partnerships or corporations. One notable exception would be publicly traded limited partnerships, since the Internal Revenue Code separately provides that any publicly held entity is to be taxed as a corporation. This means that Subchapter K of the Internal Revenue Code will apply to limited partnerships in much the same way that it applies to general partnerships.





When a limited partnership is taxed as a partnership, 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.

There will, however, be some differences between the way that general partnerships and limited partnerships are taxed, because some rules apply differently to limited and general partners. One of the most notable of these differences, from an income tax perspective, is the different ways that allocations are taxed for purposes of self-employment taxes.

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.

Under the Internal Revenue Code, payments to a limited partner are not subject to self-employment taxes, unless the distributions are in the form of guaranteed payments such as salary and fees received for services actually performed by the limited partner for the partnership. Conversely, distributions to a general partner are treated as self-employment income and subject to employment taxes.

## **Transfers of Ownership (Succession and Estate Planning)**

A partner in any 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.

In addition, there may be differences in the way that gift tax provisions apply to limited partnerships, particularly with regard to the application of valuation discounts. Limited partners have no right to participate in management, and lack of control is one factor which justifies reducing the value of a limited partnership interest for purposes of estate and gift taxes. This can be an important consideration when estate planning is one of the motivations for forming a business into which to place farming assets.

## **Dissolution**

Partners in a limited partnership have a significant degree of flexibility in determining when their limited partnership dissolves. They may specify events at the time they enter into their partnership agreement or later amend it, or they may dissolve it at any time if all of them agree. They may agree that certain events will not cause a general partner to cease to be a general partner, or that the remaining general partners or one or more newly admitted ones will continue the business without dissolution. Generally, only general partners may supervise the process of dissolution.

In general, limited partnerships liquidate in the same fashion as general partnerships, except that only the general partners (other than those who wrongfully caused dissolution) ordinarily supervise. Under the RULPA, the partners may vary the rules for conducting the liquidation, and if there is no general partner who has not wrongfully caused dissolution, the limited partners may conduct the liquidation. The RULPA also permits partners, their representatives, or their assignees to petition a court to conduct the liquidation. As





with general partnerships, limited partnerships continue in existence during the liquidation process, and the general partners and liquidators continue to have fiduciary and other duties to the partnership and other partners.

The final stage of limited partnership dissolution involves cancelling the certificate of limited partnership. The RULPA provides that a certificate of cancellation must be filed on dissolution and the commencement of winding up activities (or if there are no limited partners remaining at any point in time). The certificate must state the reason for the filing, among other things. All general partners must sign this certificate. There are also specific provisions for the notification of creditors.

## Summary

A limited partnership is a partnership with at least one general partner and at least one limited partner. It can only be formed by filing (usually with the Secretary of State) a written document which names the partners. The biggest distinctions between general and limited partnerships have to do with management rights and limited liability of the limited partners. The Revised Uniform Limited Partnership Act (RULPA) established this business structure and provides the regulations for creating, operating, and dissolving limited partnerships.

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 counsel 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.

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