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An Overview of Organizational and Ownership Options Available to Agricultural Enterprises

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The National Agricultural Law Center

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An Agricultural Law Research Article

PART I: AN OVERVIEW OF ORGANIZATIONAL AND OWNERSHIP OPTIONS AVAILABLE TO AGRICULTURAL ENTERPRISES

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Carol R. Goforth*

A. Introduction to Part I

1. Scope of This Article

This article is the first of two articles that together will provide an overview of most of the available organizational choices for persons interested in owning and operating an agricultural enterprise. Part I will address sole proprietorships, general partnerships, limited liability partnerships, limited partnerships, and limited liability partnerships. Part II will address the rules applicable to limited liability companies, corporations, and cooperatives.

The information provided in this article is general in nature does not purport to address the specific rules which apply to each of the options in each of the 50 states. For example, all 50 states have statutes governing the formation and operation of limited partnerships. Most of those statutes are based on a model act but have been modified in various ways so that the law of each state is at least slightly different from that of every other state. Notwithstanding the variation in laws from state to state, there are many attributes of limited partnerships that are generally true no matter which state law would apply. This article focuses primarily on these general rules, although it also includes references to most of the major variations on the important rules applicable to each of the entities or options discussed here.

A generic article of this kind may do more harm than good if the reader fails to understand that this is only an introduction to the topic of organizational options and not a text geared towards the specific rules that will apply in any given jurisdiction. The general information contained in this article is not intended as a substitute for the individualized advice available from experienced counsel. Rather, it is designed to help the reader learn about and compare the various options for ownership and operation of an agricultural operation.

Because this article may be consulted by attorneys as well as those who do not have a legal background, the text is written to be understandable by anyone. Footnotes contain more detailed information and citations that are likely to be of interest primarily to persons who already have a legal background, even if their normal areas of expertise do not include the law applicable to business enterprises.

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This article does not address non-profit organizations or trusts, even though both of these may be employed in connection with certain agricultural operations. Rather, the focus of these materials is on the business forms listed above.

2. Business and Tax Considerations

Although the emphasis in this article will be placed on the business attributes of each of the available options, it is practically impossible to separate business and tax considerations when it comes to choice of entity determinations. This article, therefore, includes both business law and most of the major tax considerations relating to each of the various forms of business enterprise that are discussed.

This article is organized by considering each of the different organizational options in turn, and each option is further divided into a consideration of business characteristics and tax status. For some of the options, additional information will be provided in a third subsection.

With regard to the business characteristics for each of the alternatives discussed, there is a brief overview of the form of business under state law, including an overview of how the organizational choice is selected, how it is owned, and default rules concerning such things as management rights, allocation of profits and losses, distributions, and transferability of ownership interests. This overview does not seek to take into account every similarity or difference between entity forms, but rather focuses on what will probably be the most significant factors when comparing one entity against another.

Certain potentially significant issues, such as the way in which federal and state securities laws may apply to different organizational choices, are also beyond the scope of this article. As mentioned earlier, the emphasis is on the attributes of each of the various organizational options under state law with regard to how the particular enterprise would be created and operated.

Also as mentioned earlier, this article addresses the basic tax considerations simply because these are often critical in making a decision of which form of ownership makes the most sense from an economic perspective. The tax considerations are made somewhat more complex by three facts: (1) the label applied to the entity or form of organization in question under state law will not control the label utilized for federal or state tax purposes; (2) many of the new forms of business enterprise do not fit easily into the rules that were drafted before state law of business organizations developed to the point where it is today; and (3) federal and state tax laws are not always in complete agreement. This article generally looks only at federal tax law.

Speaking very generally, there are only three different models of taxation employed in connection with for-profit business enterprises. With some of the options, the organization is ignored for tax purposes (for example, the sole proprietorship, joint ownership, and the single-member LLC are generally disregarded for federal income tax purposes, with any income or loss being reported directly by the owner). With most of the organizations discussed in this article, the prevailing model will be partnership taxation, and special care will be taken in this article to refer to “tax partnerships” and “tax partners” when the label is intended to refer to tax considerations rather than organizational status under state law. Thus a limited liability company (LLC) may be referred to as a “tax partnership,” and its members as “tax partners” because the federal income tax code does not recognize the LLC as a separate taxable entity. (LLCs will actually be addressed in part II of this series, but this same analysis will apply to organizations set up as general partnerships, limited partnerships, limited liability

partnerships (LLPs), and limited liability limited partnerships (LLLPs).) Finally, the tax code recognizes corporations, although there are two options for the taxation of a tax corporation (subchapter C and subchapter S). Both of these options will be discussed, at least in general terms, in the second article in this series.

Again, the purpose of including a discussion of tax considerations in this article is not to replace the particularized advice of a tax specialist. These materials are intended only as an overview to the tax issues, and the advice of a tax specialist such as a certified public accountant will generally be essential to assure the proper operation of any business organization, assuming that the goal of the entity is to pay required taxes but no more than necessary.

3. Special Rules Applicable to Agricultural Operations

Several states impose limitations on the ownership and operation of specified types of agricultural operations. These "anti-corporate" farming statutes vary widely from state to state, although they typically focus on such issues as the number of shareholders, the relationship among the shareholders, whether a family member "actually" conducts farming operations, and notification requirements. Colorado, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Carlina, South Dakota, Texas, West Virginia and Wisconsin all have such statutes.

The specific limitations on what can and cannot be done vary tremendously from state to state, and most jurisdictions do not have any such statutory restrictions on the ownership or operation of farms. However, in states that do have such provisions, they must be complied with. Challenges to the statutes have generally not been successful. For example, the Nebraska statue has been upheld against a void-for-vagueness challenge.[1]

It is also worth emphasizing that although these limitations and restrictions are often referred to as "anti-corporate" statutes, this label is not entirely accurate. Many of the restrictions may be applied to non-corporate enterprises. For example, the Nebraska statute has been applied by the Nebraska Supreme Court to a cooperative,[2] and limited liability companies have been statutorily declared to be syndicates and, as such, subject to the Nebraska constitutional restrictions on farm ownership.[3] More recently, South Dakota adopted a state constitutional provision which prohibits most corporations and "syndicates" from acquiring an interest in "real estate used for farming."[4] The South Dakota prohibition applies to any "limited partnership, limited liability partnership, business trust, or limited liability company," but does not include general partnerships unless nonfamily farm syndicates or

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1. Hall v. Progress Pig, 610 N.W.2d 420 (Neb. 2000).

2. Pig Pro Nonstock Cooperative v. Moore, 568 N.W.2d 217 (Neb. 1997).

3. Neb. Rev. Stat. § 21-2602(2) (1997).

4. S.D. Const. Art. XVII, § 21.

nonfamily farm corporations are partners.[5] Family farm corporations and syndicates are exempt from the provision.[6]

The purpose of this discussion is not to outline all of the potential rules affecting corporations or other businesses that seek to conduct agricultural operations in any of the 50 states. Rather, it is to alert the reader that many states do have special limitations and reporting obligations which should be researched on a case-by-case basis.

Some of the forms of business organization discussed in these two articles will be subject to varying requirements in one or more states; others (such as the sole proprietorship) should not be affected by these so-called "anti-corporate" farming statutes. However, although the popular literature tends to refer to these requirements and restrictions as being "anti-corporate," it would be a mistake to believe that only corporations are affected by such provisions. Moreover, familiarity with the requirements in one jurisdiction does not assure familiarity with the requirements in other states.

In general, any time a business organization seeks to undertake agricultural operations in any state, the state statutes should be examined to determine if there are applicable reporting requirements or other limitations. Failure to abide by such restrictions may prove to be an expensive proposition.[7] It is therefore advisable to consult with experienced counsel before undertaking farming operations utilizing any of the business forms discussed here, with the exception of the sole proprietorship, which does not appear to be affected by such statutes in any state. The following materials do not emphasize any of these requirements, and instead focus on the general attributes of each of the forms of business under consideration.

B. Sole Proprietorship

1. Business Law Status

A sole proprietorship is a business owned and operated by a single individual. While that individual may hire employees or other agents to assist him or her in conducting business operations, the proprietor is the sole owner of the business. Moreover, the business has no legal existence independent of the proprietor. There is no entity that can sue or be sued or that can shield the proprietor from personal liability for debts arising out of the business.

Because there is no separate legal entity, in most states there is no statute that governs the formation and operation of a sole proprietorship. The business will be subject to state laws and

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5. *Id.*

6. S.D. Const. Art. XVII, § 22(1). There are other exemptions as well, including exemptions for certain cooperatives, nonprofit corporations, per-existing ownership arrangements, research and experimental operations and certain other arrangements. S.D. Const. Art. XVII, § 22.

7. For example, the South Dakota provisions permit the state Attorney General to commence an action to enjoin illegal purchase or to force divestiture of land or livestock. S.D. Const. Art. XVII, § 24. The Nebraska Attorney General has also successfully sought divestiture, obtaining a settlement in May of 2001 against Christensen Farms, pursuant to which Christensen Family Farms was required to divest itself of all agricultural property.

regulations governing the operation of a business under a fictitious name, rules requiring licenses and permits for certain types of agricultural operations, and to general principles of agency and employment law if and when the sole proprietor hires agents or employees to assist with business operations.

In general, the proprietor has sole control over the business and all decisions relating to its operation. All debts of the business are also debts of the proprietor, and business assets can be seized to pay for personal debts of the proprietor.

Because the business has no legal existence apart from the proprietor, the proprietor will be able to use business assets for personal purposes and personal assets to meet business obligations. There need be no segregation of assets or income. All earnings or losses are attributed and taxed directly to the proprietor. There is no need for formal distributions from the business. There is also no specific procedure necessary to sell all or part of the business or to terminate operations. All assets are treated as being owned directly by the proprietor and can be sold by him or her at will. If the proprietor sells a partial interest in the business, there is at least the risk that this will convert the operation into a general partnership. This possibility will be discussed in more detail in part D.1. of this article.

2. Tax Status

A sole proprietorship has no separate tax status. It is not an entity recognized under the Internal Revenue Code but is treated as an extension of the owner (proprietor). This means that the proprietor is required to report all items of income and expense on his or her personal tax return. There is a separate schedule on which to calculate profit and loss from a business, but there is no separate tax on income earned from such an enterprise (other than self-employment income, which is no more than the taxpayer’s share of social security and medicaid taxes as both employee and employer). Rather, the income is added to any other taxable income attributable to the proprietor. Similarly, if there is a loss from the business, such loss can generally be deducted from other taxable income earned by the proprietor.

C. General Partnerships

1. Business Law Status

The general partnership is a very flexible form of enterprise. State partnership statutes provide default rules (i.e., rules which will govern the relationship of the parties absent specific agreement to the contrary). These default rules cover issues such as management rights and the way to calculate 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 (after a return of each partner's initial contribution). However, these provisions can be changed by agreement, and 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.

The partnership form of enterprise has been around for many years and is familiar to most legal and accounting professionals who have a business practice. As such, there is a high familiarity factor and there are a number of resources which can be relied upon for forms and research.

However, there have been some very significant developments in the recent past, and with the spread of more modern partnership statutes, some of the tried and true ways of doing things may no longer be the best.

a. The Different Uniform Partnership Acts

If this article had been written a few years earlier, the discussion of partnership law would have been considerably simpler. At that point in time, every state, except Louisiana, had adopted a version of the Uniform Partnership Act, a piece of model legislation originally promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1914. This model act, known as the UPA, resulted in a great deal of consistency in the way in which partnerships operated, even though most states had incorporated at least minor revisions to the statute as adopted in each jurisdiction.[8]

However, even though the UPA provided for a great deal of consistency and relative certainty, there were certain issues that led to a number of problems. Over the years, an increasing number of commentators suggested that it was time to revisit the question of what the ideal state partnership statute should look like. The NCCUSL undertook the reform project, and eventually promulgated a Revised Uniform Partnership Act (which was typically referred to as RUPA) in 1992.[9] The timing was, in some respects, unfortunate. Limited liability partnership (LLP)[10] legislation was sweeping the nation after having been “invented” by Texas in 1991. The original RUPA, however, did not incorporate language authorizing or otherwise dealing with LLPs, and thus in some sense the model legislation was outdated from the moment it was promulgated. Moreover, there were other criticisms of the act which prompted the NCCUSL to consider a number of amendments to the RUPA.

The first set of amendments to the RUPA were approved by NCCUSL in 1993. The changes basically responded to a number of comments and suggestions, and at the same time the official name of the act was changed to the Uniform Partnership Act (1993). Additional amendments were adopted in 1994, at which time the act was renamed the Uniform Partnership Act (1994). In 1996, further changes were made to add provisions dealing with LLPs, and the name of the statute was changed to Uniform Partnership Act (1996). Additional changes have been made in subsequent years, and it appears that more may be adopted in the future.[11]

Given the speed and frequency with which the uniform act has been amended, the choice to change the nomenclature of the uniform act is quite understandable. "RUPA" may have been a convenient acronym for the Revised Uniform Partnership Act. Re-RUPA (for Revised, Revised Uniform Partnership Act) or Re-Re-RUPA (for three sets of revisions) certainly would not be. On the

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8. The UPA, or Uniform Partnership Act (1914) may be found in volume 6 of the Uniform Laws Annotated. References in this article to the UPA are to sections of the uniform act only, rather than to the page numbers in these volumes.

9. RUPA, or the Uniform Partnership Act (1997), may be found in volume 6 of the Uniform Laws Annotated. References in this article to RUPA are to sections of the uniform act only, rather than to the page numbers in these volumes

10. LLPs will be considered in more detail in part F.1. of this article..

11. *See* official commentary to RUPA.

other hand, there is plenty of room for confusion when a state adopts the Uniform Partnership Act (1996) in a year other than 1996 and uses the official name of the act in the state statute.

Because a growing number of American jurisdictions have adopted the newer versions of the Uniform Partnership Act, and because the newer statute does make some potentially significant changes in the law applicable to partnerships, both statutes will be discussed here. Notwithstanding the official name of the newer uniform act, it often becomes difficult to keep references straight when a single document speaks about both the original UPA and the new UPA. Therefore, this article will refer to the UPA and the RUPA to explain general rules applicable to partnerships. The general rules may have been changed in any given state, and it is the applicable state statute which will control, rather than the terms of the uniform acts themselves or the general principles enunciated here.

b. General Principles of Partnership Law

i. Formation and Nature of Business

Regardless of whether the UPA or the RUPA controls in a given situation, 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.[12] 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.[13] 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.[14] (This is not a change from earlier law, because case law had generally interpreted the UPA to operate in this manner, as well.)

How then is a partnership created? Both the UPA and the 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.[15] 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.[16] On the other hand, both statutes also state than an agreement to share profits creates a presumption (or prima facie case) that a general partnership exists.[17] 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.[18] However, even though the presumption can be rebutted, sharing of profits is a risky proposition unless a partnership relationship

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12. UPA § 6(1); RUPA §§ 101(a) & 202(a).

13. UPA § 6; RUPA § 202.

14. RUPA § 202(a).

15. UPA § 7(2); RUPA § 202(c)(1).

16. UPA § 7(3); RUPA § 202(c)(2).

17. UPA § 7(4); RUPA § 202(c)(3).

18. UPA § 7(4)(a) - (e); RUPA § 202(c)(3)(i) - (iv).

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 will be documented by a written agreement, preferably drafted by experienced counsel. This serves several important functions: (1) it serves as a written record of the parties' actual agreement in case of future disputes, death of a partner, or imperfect memories; (2) it is more likely to cause parties to reflect on the more significant aspects of the partnership relationship and agree in advance as to how to deal with certain contingencies; and (3) it minimizes the risk that the parties will be surprised by the default rules contained in the partnership statute, which will apply unless the parties have agreed otherwise. (Some of the default rules may not be what people would expect or want in their business relationships.)

The foregoing discussion applies equally to the UPA and the RUPA. There is, however, one significant difference between partnerships formed under the two statutes: under the RUPA, the general partnership is explicitly recognized as an entity distinct from the partners.[19] This matters primarily in the event of litigation. Under the RUPA, where the partnership is an entity distinct from the partners, it can sue and be sued in its own name. Under the UPA, the individual partners must bring any action, or be sued in their own names. This rule may, however, have been changed in any given state.

ii. Liability of Owners

One of the biggest drawbacks to the general partnership form of enterprise is that all partners have unlimited personal liability for all debts of the partnership.[20] This means that if one partner in a farming partnership defrauds creditors of the partnership or steals money from them, all partners of the firm are personally liable for the full amount of any judgement entered because of the first partner's misconduct. Personal liability for entity debts covers contractual obligations of the business as well as tort liability. Here there is another potentially significant difference between the rules adopted by the UPA and the RUPA: the two statutes have different rules concerning the nature of each partner's individual liability for partnership debts.

The UPA was somewhat convoluted in its language and provided for joint and several liability in some instances and joint liability in others.[21] At the risk of oversimplifying, all liability under the UPA was joint, unless the partnership obligation arose out of the wrongful acts of another partner or out of another partner's breach of trust.[22] In these cases, the partners' liability became joint and several.

The distinction is important because of the nature of joint and several versus joint liability. Joint liability means that each partner is liable only for his, her or its pro-rata share of the obligation, and every partner is an indispensable party to a legal action to enforce a partnership obligation. Joint and several liability means that any partner can be held liable for the full amount, even if other partners

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19. RUPA § 201(a).

20. UPA § 15; RUPA § 306(a).

21. UPA § 15(a) & (b).

22. UPA §§ 13, 14 & 15 .

cannot be found or joined in the litigation. A partner paying more than his, her or its pro rata share would then have the burden of pursuing the other partners for contribution.

The UPA rule placed a very high burden on many partnership creditors. Consequently, several states modified these rules by amending their versions of the UPA, so that there was far less than uniformity on the question of what type of liability was imposed on general partners. According to the commentary to the official version of the UPA, as of 1996, some 18 states had adopted statutory language which essentially imposed joint and several liability on all partners for all partnership obligations.[23] Some others had changed this rule by case law or statutes outside of the partnership act itself.

In contrast to the complicated rules of the UPA, the RUPA simply provides for joint and several liability for all partnership debts.[24]

iii. Management and Authority

The starting point for considering the management rights of partners in a general partnership is the applicable statute. Both the UPA and the RUPA provide that, absent agreement to the contrary, partners in a general partnership are presumed to have equal rights to manage the partnership.[25] In addition, all partners are agents of the partnership, with at least apparent authority to bind the partnership to acts within the usual course of the partnership's business.[26] This apparent authority ceases only if the person with whom the partner is dealing knows of a restriction on that partner's actual authority. Otherwise, even if the partners have agreed to the contrary, any partner can bind the partnership so long as the act appears to be in the partnership's ordinary course of business.

Although the RUPA retains the same substantive default rules concerning management and apparent authority as appeared in the UPA, the newer statute does add some new provisions relative to the way in which a partnership might choose to operate. In particular, the RUPA provides for both a statement of partnership authority and a statement of denial.[27] Neither of these documents have any corollary under the UPA. Under the newer statute, these documents can affect a partner's authority in various ways.

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23. *See* commentary to UPA § 15.

24. RUPA § 306(a).

25. The UPA simply says that this default rule is subject to the contrary agreement of the parties. UPA § 18. At first glance, it may be hard to figure out what RUPA provides with regard to management rights, because the statutory provision dealing with management appears to be mandatory, indicating without qualification that each member has equal rights. RUPA § 401(f). However, an earlier provision in RUPA makes virtually all of the statute subject to the contrary agreement of the parties, including these management rights. RUPA § 103.

26. UPA § 9; RUPA § 301(1).

27. RUPA §§ 303, 304.

First, however, the documents must be appropriately completed and filed. The RUPA requires any statement of partnership authority to identify the partnership's "chief executive office."[28] According to the comments to section 106 of the RUPA as promulgated by the National Commissioners, this language was taken from the UCC[29] and is apparently intended to refer to:

> the place from which in fact the debtor manages the main part of his business operations.... Doubt may arise as to which is the "chief executive office" of a multi-state enterprise, but it would be rare that there could be more than two possibilities.... [The rule] will be simple to apply in most cases....[30]

Since there is no case law under the RUPA helping to define the term, this projection of simplicity may be overly optimistic.

In addition, there is some question about the effect of a statement of authority. What good does it do? The RUPA suggests that such a statement "may state the authority, or limitations on the authority, of some or all of the partners to enter into other transactions on behalf of the partnership and any other matter."[31] However, as against persons who are not partners, only grants of additional authority appear to be binding, except that properly filed denials or revocations of authority can effectively limit prior grants of additional authority.[32] Thus, the primary benefit of these statements is likely to be to provide affirmative proof of expanded authority, rather than to protect a partnership by limiting one or more partners' authority. In any event, because these provisions are so new, they are certainly worthy of some consideration before they are relied upon to change the normal rules of partnership authority.

iv. Fiduciary Obligations

A topic closely related to management power and authority is the nature of a partner's fiduciary relationship to the partnership and to the other partners. The UPA did not expressly define the extent of a partner's fiduciary obligations, although case law generally imposed very broad, fiduciary obligations on all partners. The nature of this duty may be best exemplified by the following quotation from Benjamin Cardozo, then chief judge of the New York Court of Appeals and a jurist of considerable renown: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of

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28. This term was not used in the UPA, and is not defined in RUPA, but must be included in the statement. The concept of the chief executive office is also very important throughout RUPA. It affects the law which governs the partnership, the place where records are to be kept and many other issues, as well as being required to be identified in most of the filings permitted or required under RUPA. *See* RUPA §§ 106(a), 303(a)(1)(i), 403(a), 905(b)(6), 906(b), 907(b)(3), 1001(c)(2), 1003(a)(2) & (c), and 1102(a)(2) .

29. *See* comment to RUPA § 106: "The concept of the partnership's "chief executive office" is drawn from UCC Section 9-103(3)(d)."

30. Paragraph 5 of the Official Comment to UCC Section 9-103(3)(d), quoted in the comment to RUPA § 106.

31. RUPA § 303(a)(2).

32. RUPA § 303.

the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[33]

One of the problems with this standard is that, since it did not appear in the UPA, it was not expressly made subject to the partner's rights to contract around the default rules. Thus, the extent to which fiduciary duties needed to be addressed in partnership agreements was the subject of some debate. In addition, the absence of a statutory formulation meant that the boundaries of the fiduciary duties were uncertain and subject to change as creative lawyers came up with convincing arguments as to why the times or standards of acceptable conduct had changed.

The NCCUSL, after a great deal of debate, elected not to impose such sweeping obligations upon partners, at least not as a matter of statutory default rules.[34] On the other hand, the commissioners also decided that it was not appropriate to allow partners to completely undermine all fiduciary or fiduciary-type obligations simply by contracting around them.[35] Thus, there are significant limitations on the right of partners to agree to change the fiduciary duty rules under the RUPA. Possibly because of the attempt to resolve the dispute between those who favored very strong fiduciary rules and those who favored complete freedom to contract around any statutory obligations, the RUPA's fiduciary duty provisions were among the most controversial of all of the RUPA's provisions.

In essence, although the RUPA expressly incorporates principles of law and equity to the extent they are not displaced by particular provisions of the Act,[36] under this new statute partners are presumed to owe one another only two fiduciary duties: the duty of loyalty and the duty of care.[37] The duty of loyalty is limited to an obligation to account for property or anything of value derived by the partner from conducting partnership business or winding it up, an obligation to avoid dealing with the partnership as a adverse party, and the obligation to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.[38] This duty may not be eliminated, although a partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, so long as such provisions are not manifestly unreasonable.[39] In addition, the partnership agreement may allow a specified percentage of partners to authorize or ratify a specific act or transaction that otherwise would violate the duty of loyalty, so long as they do so after full disclosure of all material facts.[40]

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33. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (NY App. 1928).

34. RUPA § 404.

35. RUPA § 103.

36. RUPA § 104.

37. RUPA § 404(a).

38. RUPA § 404(b)(1) - (3).

39. RUPA § 103(b)(3)(i).

40. RUPA § 103(b)(3)(ii).

A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.[41] This duty cannot be "unreasonably" reduced.[42]

Finally, although it is not described as a fiduciary obligation, the RUPA does specify that a partnership shall discharge his duties "consistently with the obligation of good faith and fair dealing."[43] The partners may not eliminate the obligation of good faith and fair dealing, although a partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.[44]

Although they are relatively new, a great deal has already been written about these provisions. Some commentators have praised the efforts of the drafters, but the RUPA approach has created considerable opposition from both ends of the spectrum. Those who favor the traditional approach are appalled that the standard of care is so low, and that the statute identifies what purports to be the "only" fiduciary duties of partners, although partners clearly could agree to accept additional obligations. On the other hand, those who favor allowing partners to set their own standards of care object to the fact that the RUPA includes mandatory minimum standards vis-a-vis the duty of care and duty of loyalty which cannot be eliminated or even "unreasonably" limited.

v. Sharing of Profits and Losses

One of the most important aspects of partnership law, and indeed the law applicable to almost any business association, is the way in which the law assigns participants the right to participate in profits and losses of the venture. Partnership law is particularly problematic because the default rule (i.e., the rule which will apply in the absence of any agreement by the participants to the contrary) may be counter-intuitive. Under both the UPA and the RUPA, the default rule is that all partners are to share equally in the profits and losses of the enterprise (after the return of each partner's contribution).[45] Moreover, partners are not entitled to any remuneration for services rendered to their partnership.[46] These rules may come as a surprise to the partners in a number of situations. A couple of examples may serve to illustrate some of the issues created by these default rules.

Consider the overly-simplified example of Abby, who in this hypothetical wants to form a partnership to help her with her small farming operation. She owns a small dairy farm, complete with milking equipment and a small herd of dairy cows. Now that her husband has died, she does not believe she can manage the farm operations by herself. In order to induce two individuals, Bert and Candace, to run the farm for her, she agrees to contribute the farm and its operating assets to the

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41. RUPA § 404(c).

42. RUPA § 103(b)(4).

43. RUPA § 404(d).

44. RUPA § 103(b)(5).

45. UPA § 18(a); RUPA § 401(b).

46. UPA § 18(f); RUPA § 401(h).

partnership. These assets are valued at $900,000. Bert and Candace, in turn, agree to front operating expenses for the year in the amount of $50,000 each (including necessary upkeep and repalrs). At the end of the year, if the partnership has made $100,000 in profits, how is that amount to be shared? The answer is that, absent agreement to the contrary, each partner would share equally, despite the wildly unequal contributions. Abby may be very surprised by this result.

Sometimes it is not the "wealthy" investor who is unpleasantly surprised by the default rules. Supposed Donald is an experienced farmer but lost his farm to bankruptcy. His friend, Francesca, is willing to fund a new farming operation, specializing in organic produce for local sale, provided that Donald agrees to provide services for the operation. They form a partnership in which Francesca agrees to contribute $250,000 in cash up front, and Donald agrees to contribute his services. They do not have any agreement about his salary or what happens if there are losses. Suppose after twelve months of operations, the business is broke. They rented the land, so they do not have it to sell. After selling all of the partnership assets, there are no outside creditors left, but no money either. Imagine Donald's surprise if Francesca comes to him and says that he owes her $50,000 for his share of the losses! In some jurisdictions, Francesca would have such a claim. There is a contrary view on this problem, which suggests that Donald has indeed shared in the losses because he lost the value of his services which we presume to be equal to Francesca's contributions.[47] Under this view, however, if there is $100,000 left at the end of the year, should Donald be paid half of it to equalize the return of his "contribution"? This result appears unlikely.

There are also a variety of tax and other issues that arise in the context of services-only partners, which further supports the conclusion that this is a topic which should be carefully considered by persons considering the partnership form of business. Ideally, legal and tax advisors should be consulted to minimize the risk of unpleasant surprises.

One other point should be made. The RUPA provides (at least in the absence of an agreement to the contrary) that the partners in a general partnership are deemed to have an account which is to be "credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits" and "charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses."[48] These rules basically describe a "capital account," which would be the typical way in which a partner's right to share in profits and losses in accounted for over time. In fact, the Internal Revenue Code sometimes requires that such an account be maintained if the partnership has made certain allocations of losses that it wants to have respected for federal tax purposes.[49] However, because these rules do not require that the value of services are presumed to be included in

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47. For contrasting views on whether someone in Francesca's situation might prevail, compare *Richert v. Handley*, 50 Wash.2d 356, 311 P.2d 417 (1957) and *Richert v. Handley*, 53 Wash.2d 121, 330 P.2d 1079 (1958) (services-only partner who received no other compensation should not have to contribute towards losses), with *Kovacik v. Reed*, 49 Cal.2d 166, 315 P.2d 314 (1957) (services-only partner liable for share of losses in venture).

48. RUPA § 401(a)(1) & (2).

49. For a more detailed discussion of the requirements concerning the maintenance of capital accounts in order to insure that any special allocation of income or loss have "substantial economic effect," see infra part C.2. of this article..

the partner's "capital account," the RUPA is unlikely to solve the potential uncertainty that may exist if partners make contributions in different ways and fail to address how losses are to be shared.

vi. Transfer of Ownership in the Partnership

Consider now the issue of a partners's ownership interest in the partnership. What is it that the partner owns? How is that ownership conveyed? Can creditors of a partner recover against that partner's interest in a partnership, and if so, how?

There are a couple of reasons why the rules applicable to the transferability of partnership interests deserve some special consideration. First, they are very different from the rules applicable in the corporate setting, or indeed, the rules applicable to most property interests. In a corporation, a shareholder is generally entitled to sell his, her or its stock at any time to any purchaser, and the purchaser simply steps into the rights held by the selling shareholder. This is also true of most kinds of ownership interests. In the corporate setting, while this right can be modified by agreement, the default rule essentially codifies what has long been regarded as a central attribute of the corporate form: free transferability of interests. In contrast, a partner in a partnership is not generally entitled to transfer all of the attributes of ownership to any other person, absent the unanimous consent of every other partner. The default rule under both the UPA and RUPA is that a partner can transfer his or her economic right in profits and distributions but not any of the other rights traditional vested in partners. The assignee would not become a partner, but only an assignee with very limited rights. Again, these rules are subject to contrary agreement of the parties, but absent such an agreement, a partner's right to sell are limited.

This leads to the second reason why these rules are important and another difference between owning a partnership interest and owning other types of property. Consider the case of a corporation, ownership of which is usually evidenced by shares of stock. A shareholder has very limited rights and very limited responsibilities as a result of such stock ownership. In most cases, it should not matter who else owns shares. In a partnership, however, every partner has certain agency powers to bind the partnership, and the financial worth of every partner may be important to both the ability of the partnership to borrow funds and to repay them without increasing the individual liability of other partners. Thus, who one's partners are can matter greatly.

In addition, the lack of free transferability has economic consequences that may be important in any given situation. Exit strategies are always worth considering, and the fact that it may be hard to sell partnership interests (both in terms of finding a buyer and in terms of getting the required consents) may mean that this is economically less attractive than some other forms of business enterprise. (On the other hand, if one of the intended purposes is to insulate assets of the business from claims by creditors of the individual participants, this may be an actual advantage in some situations.)

The basic rules are not hard to state. Both the UPA and the RUPA make a partner's interest in a partnership personal property.[50] The uniform acts also provide that a partner's interest may be assigned.[51] Such assignment, however, does not automatically guarantee that the assignee will become a partner. Under both the UPA and the RUPA, absent agreement of the other partners, the

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50. UPA § 26; RUPA § 502.

51. UPA § 27; RUPA § 503.

assignment entitles the assignee to receive only the profits to which the assignor would have been entitled.[52] No other rights are transferred. In other words, absent the agreement of the other partners, an assignee of a partnership interest receives only the economic rights of a partner and not the management rights. The non-economic rights, including the right to manage and to vote in partnership decisions, remain with the assignor, who continues as a partner in the partnership until and unless removed as provided by law or the applicable partnership agreement.

However, partners may admit new partners by unanimous consent or, if they have provided otherwise in their agreement, under any procedures to which they have agreed.[53] It is relatively common to have partners pre-approve certain classes of transferees for admission to the partnership as partners, particularly family members or successor enterprises in the event that one or more of the original partners is a corporation or other business entity. It is also relatively common for partnership agreements to provide that the only approval necessary to admit new or substitute partners is from certain specified partners, or a specified percentage, less than 100 per cent, of the partners.

The UPA does not expressly provide for restrictions on the assignment of a partner's economic interest in a partnership, although these are not unheard of.[54] The RUPA essentially continues these rules but expressly allows restrictions on the usual principle of free assignability of economic rights.[55]

Because a partner's interest in the partnership is personal property, it should be possible for a partner's creditor to obtain and perfect a security interest under the Uniform Commercial Code.[56] The UPA and the RUPA also permit a creditor to obtain a "charging order" against a debtor partner's interest,[57] although the procedure is designed for collecting judgments rather than securing the debt at the outset of a transaction. In addition, the process is somewhat confusing and appears to be rarely utilized in practice.

Anyone who advances credit to an individual based on such person's ownership interest in a general partnership should be aware that, absent agreements to the contrary, foreclosure of that interest will gain the creditor only the partner's economic rights and not any management authority. Moreover, the partnership agreement may impose restrictions even on the ability of a partner to transfer the economic rights. The partner has no direct control over a proportional interest in the

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52. UPA § 27; RUPA § 503.

53. UPA § 18(g); RUPA § 401(i).

54. Some courts have approved such restrictions under the UPA as adopted in the applicable jurisdiction. *See e.g*., Nicolas M. Salgo Assocs. v. Continental Ill. Properties, 532 F. Supp. 279 (D.D.C. 1981) (applying District of Columbia law; anti-assignment provision applied to transfer, including transfer by operation of law). On the other hand, unreasonable restraints on the transfer of partnership interests have been prohibited. *See* Battista v. Carlo, 57 Misc. 2d 495, 293 N.Y.S.2d 227 (1968) (court narrowly interpreted restriction in partnership agreement so as to preclude only sales to nonpartners).

55. RUPA § 103 contains no provision limiting the ability of partners to contract around any of the default rules relating to transfer of partnership interests.

56. *See, e.g*., Madison Nat'l Bank v. Newrath, 261 Md. 321, 275 A.2d 495 (1971).

57. UPA § 28; RUPA § 504.

partnership's assets, nor any right to grant a lien on any part of partnership property without consent of the other partners. Moreover, a lender to a partner who is unable to pay a debt which is secured by a partnership interest in effect ranks below creditors of the partnership if the partnership is also insolvent. Partnership creditors will generally have superior rights in regards to partnership property.

vii. Dissolution and Termination

Before describing the statutory rules governing the termination of general partnerships, it is important to review some of the legal terminology because some commonly used English words are given special meanings in this context. Both the UPA and the RUPA divide the demise of a partnership into three phases: dissolution, winding up, and termination.[58] A partnership that has "dissolved" continues its existence for the purpose of winding up its business. Termination occurs when the winding up process is complete. Regrettably, this does not accord with the every-day meaning typically associated with these terms. Further confusing matters is the fact that "termination" under federal income tax law is a concept which does not correlate with state law and may not occur even though a partnership has dissolved and terminated under state law.

The initial step in the dissolution process is the dissociation of one or more partners. Under both the UPA and the RUPA, dissociation means a partner's withdrawal from the partnership, either voluntarily (such as by retirement or simply announcing an intent to withdraw) or involuntarily (such as by death, incapacity or removal by the other partners).[59] Under the UPA, dissociation triggers automatic dissolution of the partnership (dissolution being defined as the change in relationship caused by any partner's ceasing to be associated with the partnership).[60] Under the RUPA, dissociation need not be followed by dissolution and winding up.[61] Rather, the RUPA provides that dissolution may be followed by winding up of the business or, in certain circumstances, the business may be continued and the dissociating partners paid off.

Actually, the business of a partnership may be continued even after a partner's withdrawal under either the UPA or the RUPA. Under the UPA, it is possible only if the partnership agreement provides for it or if 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).[62] Under the RUPA, even where a partner has rightfully dissociated, the statutory default rule is that remaining partners can elect to continue the business.[63] Moreover, under the RUPA, a wrongful dissociation is presumed not to trigger dissolution and winding up.[64]

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58. UPA §§ 29, 30 & 37; RUPA §§ 601, 802 - 807.

59. UPA § 29, 31; RUPA §§ 601 - 603.

60. UPA § 29.

61. RUPA § 603(a).

62. UPA § 38(2)(b).

63. RUPA § 802(b).

64. RUPA § 801(2)(i).

The RUPA is not entirely clear as to whether a partner's withdrawal triggers dissolution at all. It may be that a wrongful withdrawal triggers neither dissolution nor winding up, or that it triggers dissolution without the winding up (which is what the UPA would have provided). In any event, the RUPA is slightly more flexible with regard to continuation of the business after a partner's withdrawal, but the flexibility in no way diminishes the need to pay particular attention to drafting partnership agreement provisions which carefully explain the parties' rights and obligations in the event of withdrawal of one or more partners.

Under the UPA, dissolution is triggered by any of the following:[65]

1. Withdrawal of a partner--A partner has the legal ability to quit the partnership at any time, even if the partnership agreement purports to prohibit such withdrawal. If a partner withdraws in violation of a provision in a partnership agreement, the partnership may recover any damages caused by the wrongful withdrawal (such as the value of the lost services or the cost of finding a replacement), and the partner may lose the right to participate in winding up the partnership's business.
2. Death of a partner who is an individual.
3. Bankruptcy of any partner or the partnership itself.
4. Expulsion of a partner pursuant to a right granted in the partnership agreement--The power to expel exists only if there are bona fide reasons for the expulsion in accordance with the terms of the agreement.
5. Events specified in the partnership agreement--Many partnership agreements contain a specific undertaking or time period, which, when complete, will trigger dissolution of the partnership.
6. Agreement of all partners--This is a statutory right; the partnership agreement can also provide for dissolution upon the vote of less than all of the partners.
7. Any event making it unlawful to carry on the business of the partnership or for these partners to do so.
8. Judicial dissolution--Upon partners' petition, a court may order dissolution upon proof that a partner has repeatedly breached his or her partnership obligations, the business can be carried on only at a loss, or "circumstances render a dissolution equitable."

The UPA only permits expansions of the causes of dissolution. There is no statutory authority to reduce the list of things that will trigger dissolution.[66] However, the UPA does allow the partners to agree, either in advance or at the time, that upon certain events of dissolution the remaining partner or partners may or will continue the business and succeed to its assets and liabilities, cashing out the departing partner or that partner's survivor's legal representative.

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65. All of these events are listed in UPA § 31. *See also* RUPA § 801.

66. A few jurisdictions by modification of the UPA or, more rarely, by case law permit the partners to vary this list by agreement.

The RUPA contains many of these rules, as well.[67] However, this statute does appear to make most of the list of events which would ordinarily trigger dissolution subject to contractual modification in a partnership agreement.[68]

2. Tax Status

a. Introduction to Partnership Income Taxation

One of the primary advantages of the partnership form of business is that there is no entity-level tax imposed on partnerships. (Note that it is possible that a partnership can elect to be taxed as a corporation if it so desired.[69] Under our current tax structure, however, it is quite unlikely that a partnership would elect corporate tax status.)

Assuming that a partnership (regardless of whether it is formed under a version of the UPA or the RUPA) files no special election to be taxed as a corporation, the basic framework of partnership taxation follows: Each item of income and loss is passed through to the partners in accordance with either the default rules or the partnership agreement if the parties have agreed to a different allocation. Although there are limits on the extent to which partners can utilize partnership losses to offset other income, in general, partnership taxation is likely to be more advantageous than corporate taxation, which imposes one level of tax on earnings of the entity and then another level of tax when income is distributed to the shareholders as dividends. Moreover, corporate losses can only be utilized by the corporation and may not be used by shareholders to offset other items of income at the personal level.

Partnerships and partners are taxed pursuant to rules contained in Subchapter K of the Internal Revenue Code.[70] While Subchapter K consistently refers to partnerships and partners, it is important to remember that, with very few exceptions, these rules will basically apply to all unincorporated businesses. Thus, references in the Internal Revenue Code to “partnerships” and “partners” should be understood as references to entities taxed as partnerships and persons taxed as partners, regardless of how they are characterized by state law. With some notable exceptions, the following discussion will also apply to other unincorporated businesses.

As with state partnership law under the UPA, Subchapter K represents a blending of the aggregate and entity concepts. If partnerships were treated as a pure aggregate (i.e., no more than an association of individuals), each partner would be treated as if he owned an undivided interest in the partnership assets and conducted a proportionate share of the partnership business. The partnership

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67. RUPA § 701.

68. RUPA does not list most of these circumstances in the statutory section which restricts the power of partners to contract around statutory default rules. *See* RUPA § 103.

69. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301 (1997). These regulations are generally referred to as the “Check-the-Box” regulations, because they presume partnership taxation for unincorporated domestic businesses with 2 or more members allow any such enterprise to elect corporate tax status by “checking a box” on an election form.

70. I.R.C. §§ 701-761.

would be irrelevant. On the other hand, if a pure entity approach was adopted, the partnership would be treated as a separate entity for tax purposes, and each partner would own an interest in the partnership rather than in the underlying assets. Subchapter K adopts an aggregate approach for some purposes and an entity approach for others. For example, a partnership is treated as a conduit which passes income through to the partners to be reported on their individual returns. This is consistent with the aggregate approach. On the other hand, for purposes of determining the amount, character and timing of partnership items, an entity approach is adopted. The hybrid entity-aggregate approach to partnerships accounts for much of the complexity of Subchapter K but generally produces sensible results.

In essence, the starting point for tax purposes is the calculation of the income of the partnership.[71] Once these amounts are calculated, the partnership is required to file an informational federal income tax return.[72] (Most state statutes also require the filing of an entity return for state income tax purposes. However, state taxation is beyond the scope of this article and will not be addressed here in any detail.)

The calculation of profits and losses may be different for tax and economic purposes. For example, the proceeds received by a partnership from a life insurance policy may not be included in computing profits for income tax purposes,[73] although these proceeds may constitute a significant addition to the economic assets of the entity. The informational return must include each partner's allocated share in the partnership's income or losses. This is not the same as amounts that may have actually been distributed to the partners but, instead, represents the partners' proportionate interests in items of income or loss.

b. Allocations of Income and Loss to the Partners

The Internal Revenue Code provides partners with considerable flexibility to structure their profit- and loss-sharing arrangements for tax purposes. Thus, a partnership agreement might provide: (1) that entity tax profits and losses will be shared among the partners in the same manner; (2) that the shares of particular partners' in the tax profits of the partnership will be different from the same partners' shares of the tax losses of the partnership; and/or (3) that particular items of tax income, gain, loss, deduction or credit will be shared differently than the overall entity tax profits and losses. However, this flexibility is subject to limitations concerning the requirement that special allocations have "substantial economic effect," and by a special provision that may mandate that gain, loss, or depreciation with respect to particular contributed properties be allocated in a certain way.[74] These special limitations are discussed briefly below.

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71. I.R.C. § 703.

72. I.R.C. § 6031(a).

73. I.R.C. § 101(a)(1).

74. *See, e.g.*, I.R.C. § 704(c). This Code provision deals with the concept of built-in gain, which occurs when a partner contributes property to a partnership in which the partner's basis is different from then-current fair market value. In this instance, when that asset is later sold or transferred, 100% of the built-in gain(ie, that proportion of gain or loss attributable to the difference between basis and fair market value at the time of contribution) will be allocated to the contributing partner.

The Internal Revenue Code provides a default rule for sharing overall entity tax profits and losses in two circumstances: (1) where the partnership agreement does not address the issue; and (2) where the partnership agreement provides for an allocation for tax purposes which does not have "substantial economic effect."[75] In either event, the tax default rule is that the tax profits and losses will be shared in accordance with the partner's "interest in the partnership," determined by taking into account "all facts and circumstances."[76] The regulations provide that the interests are "presumed to be equal (determined on a per capita basis)."[77] Thus, the tax default rule is that profits and losses for tax purposes will generally be shared equally unless a different sharing arrangement is provided in the partnership agreement or by law (the applicable partnership act). Since the UPA and the RUPA both provide for equal allocation of profits and losses, any modification of the tax default rules will have to be in the partnership agreement.

The tax default rule also applies where the partnership agreement makes an allocation that is subject to the "substantial economic effect" test but does not satisfy it. The regulations prescribe a number of rules that must be met in order for such an allocation to satisfy the "substantial economic effect" requirement. The conceptual objective of these economic effect rules is to insure that special allocations for tax purposes will be matched by parallel allocations for economic purposes.

On the other hand, the substantial economic effect test is generally only relevant where some special allocation is made for tax purposes that is different from the general manner in which profits and losses are being shared, since an allocation in accordance with the partner's interest in the partnership is the default rule if an agreed allocation does not have substantial economic effect. Thus, if both the tax and economic profits and losses, and all items thereof, of the partnership are allocated in the same manner, either under the terms of the partnership agreement or under the default rules of the state partnership act, the allocations should generally have economic effect. This does not require that the partnership agreement allocate everything equally between the partners in order to avoid any possible problem with the substantial economic effect rules; the only requirement is that the partnership agreement avoid having an allocation of a particular item of profit or loss that is different from the way that other items of profit or loss (from both the tax and economic perspectives) are allocated to a given partner. In other words, it is perfectly acceptable to have partner A receive a 50 percent interest in every item of profit and loss (for tax and economic purposes), while partners B and C each receive only a 25 percent interest. The potential problem arises if A's usual sharing ratio is 50 percent but the partnership agreement purports to allocate a specific item of gain or loss to A in a different proportion.

If a partnership agreement does contain a special allocation, it will be respected for tax purposes only if it has substantial economic effect.[78] The tax regulations provide detailed guidance on this precise point, i.e., insuring that any agreed allocations will have both tax and economic effect. Before considering these regulations in more detail, it is worth noting one other important aspect of partnership taxation, it is the allocation of income or loss which is the taxable event, not the subsequent distribution of earnings.

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75. I.R.C. § 704(b).

76. Treas. Reg. § 1.704-1(b)(3)(i).

77. *Id.*

78. I.R.C. § 704(b).

When partnership income, determined as of the end of the year, passes through for tax purposes to the partners, they must report it, regardless of whether the partnership's profits have actually been distributed to the partners.[79] On the other hand, actual distributions that do not exceed a partner's share of previously taxed profits should not produce additional taxable income to the partner at the time of distribution.[80] This single tax approach is accomplished by providing that a partner's basis in the entity is increased at the end of the entity's taxable year by the partner's share of entity income and decreased by actual distributions. On the other hand, an actual distribution to a partner does not generally result in additional gain to the partner except to the extent a cash distribution to the partner exceeds that partner's basis in the entity before the cash distribution is taken into account.

The timing and nature of distributions can cause a problem, however. Take this simple example. A/B partnership has $100,000 in tax profits at the end of year 1. If A and B share equally in partnership income, A and B will each report $50,000 of the entity profits and will each increase their entity basis by $50,000. If, for example, the entity then actually distributes $50,000 cash to each in April of Year 2, the distribution would not exceed the previously taxed share of each, as represented by the increased basis of each in their interests in the entity. No additional gain would be recognized on the distribution, and the basis of each in their respective entity interests would be reduced by $50,000. Assume this distribution brings the basis of each back to zero. Assume further than the entity has enough available cash flow to make a further cash distribution to each on July 1, of Year 2 in the amount of $10,000 each. If this is an unconditional distribution, each of the partners will recognize an additional gain of $10,000, since the cash distributed will exceed the zero basis of each in the entity. On the other hand, if this July distribution is delayed until after the end of Year 2, the partners will be able to increase their bases in the entity interests for their share of the Year 2 profits before any recognition event, and assuming those shares were at least $10,000 each, no gain will be recognized with respect to the actual distribution.

Thus, generally, if an interim distribution during the year simply represents the undistributed share of previously taxed profits, no additional gain should be recognized on the distribution.[81] On the other hand, if all previously taxed profits have already been distributed, and the interim distribution is from the current year's earnings, gain may be recognized if the interim distribution is unconditional. This problem is solved where the distribution against current earnings is clearly characterized as such--as an "advance," or "loan," or "draw" against those current earnings. In this event, the interim distribution is tantamount to a loan which will be paid back out of earnings determined at the end of the year and subject to repayment by the partner to the extent those earnings are not sufficient to fully offset the earlier draw. The tax regulations provide that no distribution occurs with respect to a loan, draw, or advance until the end of the partnership's taxable year, as of which date the partner's earnings for the year are determined, and the basis in their entity interests will be increased to reflect

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79. I.R.C. § 701.

80. I.R.C. § 731.

81. *But see* I.R.C. §§ 704(c), 737 (certain distributions in connection with contributed property trigger gain); 707(a)(2)(B) (distributions that represent proceeds from "disguised sale" of contributed property trigger gain or loss); 751(b) (certain distributions trigger gain under disproportionate distribution rules).

such earnings.[82] If the advance to a partner does not exceed the partner's profit share for the entire year, therefore, no additional gain should occur with respect to the actual distribution.

Thus, for example, if the $10,000 distributed to each A and B on July 1 of Year 2, is treated as an advance or draw against Year 2 profits only, A and B would not be taxed on receipt of the advance on July 1. If the entity has $20,000 of profits for all of Year 2, A and B would report their $10,000 share each, as determined at the end of the year. The basis of each would increase for their $10,000 share of profits. Then, when the $10,000 advance to each is canceled against the $10,000 share of profits of each for all of Year 2, the cancellation will be treated as a distribution of money occurring at the time of cancellation in the amount of the cancellation. No additional gain will be recognized on the deemed distribution since each will have $10,000 of new basis in their entity interests to offset the deemed distributions.

c. Special Allocations and Substantial Economic Effect Rules

In general terms, a tax allocation which differs from the partner's "interest in the partnership" will not be respected for tax purposes if the allocation does not have "substantial economic effect."[83] Tax regulations describe each partner's "interest" in the entity as signifying "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."[84] The tax regulations provide a presumption that the interests are equal but describe a number of factors which can be taken into account in determining each partner's "interest."[85]

Generally, if a special tax allocation of income, gain, loss, deduction or credit is made to a partner that is different from that partner's "interest" in the partnership, the item will be reallocated for tax purposes in proportion to the partners' usual interests unless the special allocation has "substantial economic effect." Since an allocation in accordance with the partners' "interests" is the default fall-back rule, allocations that are made in accordance with such "interests" will generally cause no problems. If the partners' distributions rights are uniform (that is, no special allocations are provided), whether by reason of the default sharing rules of the UPA or RUPA, or as provided in a partnership agreement, the formal requirements of the "substantial economic effect" test of the tax regulations will therefore be inapplicable.

On the other hand, if a special allocation is made of tax income, gain, loss, deduction, or credit to a partner or partners that is not in accord with that partner's or those partners' general sharing rights, the substantial economic effect test will have to be satisfied if the allocation is to be respected for tax purposes. A simple example will illustrate the issue. Assume that A and B are equal partners in AB partnership. The partnership has $100,000 in net income for tax and economic purposes for Year 1. The normal sharing arrangement is 50/50 for both tax and economic purposes. Assume that A and B have both agreed that the entire $100,000 net income will be allocated to A for tax purposes because A is in a lower tax bracket than B, while the $100,000 net income for economic purposes will

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82. Treas. Reg. § 1.704-1(a)(1)(ii).

83. I.R.C. § 704(b).

84. Treas. Reg. § 1.704-1(b)(3)(i).

85. Treas. Reg. § 1.704-1(b)(3)(i).

be split as usual between A and B. If A and B were allowed to do this, the primary impact would be to lower the amount of taxes paid. Partners would be free to allocate tax items among themselves in order to reduce tax liabilities without changing their economic claims against the entity. The "substantial economic effect" requirements are designed, in effect, to prevent tax allocations divorced from economic allocations. Oversimplifying a bit, the substantial economic effect requirements generally require a special tax allocation be accompanied by a parallel allocation for economic purposes.

The regulations provide that the "substantial economic effect" test as applied to special allocations is actually two tests: (1) the allocations must have "economic effect" as provided in the regulations,[86] and (2) the economic effect of the allocations must be "substantial."[87] Thus, even if an allocation has "economic effect," it may still be ignored for tax purposes if the economic effect is not "substantial."

The economic effect part of the test is easier to understand in conceptual terms than in the complex provisions of the tax regulations which implement it. Very generally, the point of the test is to require that an allocation of income, gain, loss, deduction, or credit to a partner for tax purposes be accompanied by a parallel allocation for economic purposes, one that will impact on the partner's economic claims against the partnership. The key mechanism for tying tax and economic allocations together is a capital account for each partner. In essence, in order for tax allocations to be considered to have "economic effect," the tax regulations require that the partnership agreement provide the following: (1) that the partnership maintain capital accounts for each partner in accordance with rules provided in the regulations; (2) that upon liquidation of the partnership, distributions to the partners be made in accordance with their remaining positive capital account balances; and (3) that any partner whose capital account shows a deficit upon liquidation be required to repay the amount of that deficit to the partnership within a specified period of time.[88] These requirements have obvious drafting implications, since a partnership agreement will have to provide for them, as there is no equivalent statutory default rule under either the UPA or the RUPA.[89]

The requirements relating to the maintenance of the capital account are generally intended to provide a running series of adjustments made on an economic basis to each partner's account that will parallel allocations for tax purposes. For example, if A contributes property worth $100,000 to the partnership, with a tax basis of only $50,000, and B contributes property with both a value and tax basis of $100,000, the regulations would require that these contributions be "booked" by crediting the capital account of each with $100,000, reflecting the equal value of the contributions, even though the partnership's tax basis in the property contributed by A would be only $50,000. If the partnership sells the property contributed by A for $110,000, ignoring any basis adjustments, it will have a book profit of only $10,000 with respect to the property, although it has a tax gain of $60,000 and, assuming equal

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86. Treas. Reg. § 1.704-1(b)(2)(ii).

87. Treas. Reg. § 1.704-1(b)(2)(iii).

88. Treas. Reg. § 1.704-1(b)(2)(ii)(b).

89. RUPA does presume the existence of capital accounts. RUPA § 401(a). RUPA does not, however, incorporate all of the requirements embodied in these federal tax regulations.

sharing, $5,000 of that book profit would be added to the capital accounts of each of A and B.[90] The capital accounts of each would not be adjusted for the $50,000 of tax gain in addition to the $10,000 of book gain. Similarly illustrating that the capital accounts are maintained on an economic rather than tax basis, if the partnership were to realize $10,000 in taxable and $10,000 in tax exempt incomes, for a total of $20,000 in income, $10,000 would be credited to the capital account of each of the partners. If an actual distribution is made to the partners, their capital accounts are decreased by the amount of distribution received by each.

The capital account, as maintained under the tax regulations, thus represents the running total, constantly adjusted, of the economic claims the partner has against the partnership. The interim adjustments that are made to the capital accounts have an economic impact, since the partnership agreement must generally provide that liquidating distributions to partners will be governed by their capital account balances at that time.

Under the requirements described above, a partner who has been allocated more losses than the total value of the partner's contributions will show a deficit capital account balance, which the partnership agreement must generally require be repaid.[91] For example, if A and B each contribute $100,000 as their original contributions, and the partnership has losses of $150,000 over its operating history, with all of those losses being allocated for tax purposes (and, as a corollary, for capital accounting purposes) to B, the capital account balances of each would look like this (taking only these facts into account):

	A	B
Opening Balance	$100,000	$100,000
Losses	(0)	(150,000)
Balance	$100,000	($50,000)

Under the third economic effect test requirement, the partnership agreement would have to provide that B must repay $50,000 to the partnership, which would use it to pay creditors or to distribute to other partners. Here, B would repay $50,000, which, added to the $50,000 the partnership otherwise has remaining ($200,000 original contributions less $150,000 losses), would be distributed to A as a return of A's $100,000 capital account balance.

On the other hand, B may be reluctant to have to pay not only creditors but also partners for amounts that were always intended to be at risk in the venture. On the facts of the example, however, if B is required to repay the $50,000 capital account deficit, B's liability has not been limited only to the original $100,000 contributed by B, and A will have lost nothing at all out of A's original contribution.

Because this result may be unpalatable, the tax regulations provide alternative ways in which the third part of the economic effect test can be satisfied. One alternative is to eliminate the third

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90. The required tax treatment of the built-in gain that is caused by the fact that the contributing partner had a basis in the property that was less than its fair market value at the time of contribution is the primary instance where the Code would in effect mandate a special allocation. I.R.C. § 704(c). All of such built-in gain ($50,000 in the textual example) must be allocated to the partner who contributed the property. The additional $10,000 in gain (which is attributable to post-contribution appreciation) would be allocated to the partners in accordance with their interests in the partnership or as provided in the agreement if the agreement complies with the rules concerning special allocations.

91. *Id.*

requirement (the deficit account repayment obligation) but provide in the partnership agreement that no allocation will be made to a partner that will cause or increase a deficit in that partner's account after taking any anticipated distributions to that partner into account.[92] Thus, for example, a partnership agreement provision of this sort would have allowed B in the example above to be allocated no more than $100,000 of the $150,000 stipulated losses. Under this approach the partnership agreement must also provide for a "qualified income offset."[93] Under such a provision, a partner who receives an unexpected allocation or distribution that causes or increases a deficit account balance must then be specially allocated items of income or gain "in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."[94]

There is also a purely practical alternative to the requirement that any capital account deficit be repaid. Even if the partnership agreement does not contain the third requirement, allocations that would otherwise be respected (because the first two economic effect tests are satisfied) will be respected as long as they, in fact, do not create any capital account deficits, because to that point the allocations do have economic effect. Thus, for example, the allocation of the first $100,000 in losses to B would have economic effect as to B because there was that much value to start with in B's capital account. It would only be the remaining $50,000 allocation, after B has nothing more to lose in an economic sense, that would not be respected if B had no repayment obligation and the "qualified income offset" alternative is not provided.

The tax regulations also require that the economic effect be “substantial,” which essentially means that the economic and tax effect of any allocation must be matched on a dollar for dollar basis. At this point, it is probably worth re-emphasizing that the point of this extended discussion of tax regulations is not to create a do-it-yourself guide for persons considering the possibility of establishing a partnership out of which to run their agricultural operation. Rather, this article is intended to provide the kind of background information that should make it easier to consult with a tax advisor and to effectively communicate concerns and preferences. In addition, this information may make the ultimate advice provided by such an expert easier to understand. This article should not be read as an alternative to consulting with a tax advisor but in connection with such consultation.

Turning now from the issue of whether a special allocation has “substantial economic effect,” there are other important limitations on the partners’ ability to utilize losses that are allocated to them. Ideally (at least from the partners’ perspective), when a partnership allocates losses to the partners, those partners would be able to use such losses to offset other income, thereby reducing overall tax liability.

One of the most important of the limitations on this ability is the rule that a partner’s deduction for his or her distributive share of partnership loss is limited to his or her basis at the end of the partnership tax year in which the loss occurred.[95] A partner’s initial basis depends on how that

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92. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(1), (2), (3).

93. *Id.*

94. *Id.*

95. I.R.C § 704(d); Treas. Reg. § 1.704-1(d)(1).

partnership interest was acquired,[96] and this basis is continually adjusted to reflect the partner's share of partnership income, expenses, and distributions. Basis is increased primarily by additional contributions or deemed contributions and the partner's distributive share of partnership income.[97] It is decreased primarily by distributions or deemed distributions, and the partner's share of distributive losses.[98] One benefit of being a general partnership is that a partner is deemed to contribute an amount of cash equal to that partner's share of partnership debts,[99] although this also means that a taxpayer recognizes income when his or her share of such debts are discharged without payment.[100] For any given partner, these rules may or may not present limitations on the availability of losses to offset other income. Additional tax rules exist which may further restrict a partner's ability to utilize losses that are attributable to nonrecourse debts.[101]

Another limitation on the usefulness of losses arises when those losses are allocated to partners who are not actively engaged in the business of the partnership. The Internal Revenue Code imposes significant limitation on the right of such partners to utilize such "passive losses." Speaking very generally, losses from a passive trade or business activity may be taken only against gains from passive activities; they may not be used to offset other income (nonpassive activity gains).[102] An activity is considered to be "passive" if the taxpayer in question (the partner) does not "materially participate" in the activity or rental activity. A partner will be recognized as "materially participating" in the trade or activity only if he or she "is involved in the operations of the activity on a basis which is regular, continuous and substantial."[103]

The point of this discussion is to provide the type of background information that should make it possible to understand and respond to recommendations from a tax adviser about these types of issues. In very broad terms, a partnership does not itself pay taxes. Taxes are paid on the income by each partner, in proportion to his or her distributive share, regardless of how much is actually paid out by the partnership each year. Subject to numerous rules, some of which have been briefly described here, losses are also passed through to the partners. Partnership income taxation and accounting are, however, sufficiently complex that it is generally advisable for each partnership to consult with an

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96. The basis rules are complicated, and will not be reviewed in detail here. For a relatively simple explanation of these rules, see Jerold A. Friedland, *Understanding Partnership and LLC Taxation* 129-79, LEXIS PUBLISHING (2000).

97. *See generally* I.R.C. §§ 705(a)(1)(A), 722, 752(a).

98. *See generally* I.R.C. §§ 7705(a)(2), 733, 752(b).

99. I.R.C. § 752(a), 722.

100. I.R.C. § 702.

101. I.R.C. § 465. This provision limits a taxpayer's deduction for losses from an activity to the amont at risk in such acticity (i.e., his capital contributions, plus liabilities for which he or she bears personal liability.

102. I.R.C. § 469.

103. I.R.C. § 469(h)(1).

experienced tax advisor about the specifics of how these rules will apply to any given situation. Individual partners may also need individualized tax advice.

3. Review of Important Drafting Considerations

A partnership agreement may be as long or short as the partners need. To the extent that the partnership statute includes default rules that coincide with the partners' preferences, it is not even essential that a partnership agreement address all of the important issues that are likely to arise during the course of business operations. However, there are some advantages to having a written agreement incorporate rules that would apply even in the absence of the agreement: (1) it prevents or at least reduces the chances of future arguments about the actual terms of the agreement; (2) if the partners forget the default rules, it is easier to check the agreement than to call the attorney or look things up in the statutes; and (3) it reduces the chances that the partnership will inadvertently incorporate default rules which are different from what the partners had expected.

The following is a list of substantive provisions which might be included in a formal partnership agreement. Even if no written document is prepared, these are certainly the kinds of issues that partners should agree upon in advance:

PROVISIONS FOR FORMAL PARTNERSHIP AGREEMENTS

1. **Names and Addresses of Partners** - This may also include the status and state of organization for non-individuals.

2. **Name of Partnership** - Any conflict with the trade name of another or similar business name should be resolved; the agreement might need to recite any relevant permissions and who granted those permissions. If the partnership wishes to register its name, this may also be included in the agreement, along with authorization to pay any required fees or renewals. These provisions may address what happens to the name of the partnership upon reorganization, any provision for the continued use of a decedent partner's name, and any restrictions on using the partnership name in other activities.

3. **Purpose of Partnership** - A partnership agreement might specify the authorized business activities in order to limit the scope of usual partnership activities. If this is done, the agreement may also recognize the possibility that these purposes may change. Any limitations on business activities should be expressed rather than implied, and it should be understood that any limitation on the authority of any partner to conduct operations within the usual scope of the partnership's activities is not likely to be effective as against those who do not know of such restrictions. This may also be the place where any limitations on the rights of partners to engage in competitive business activities may be expressed.

4. **Term of Partnership** - The partnership agreement may have a particular term, set forth in terms of a particular date or the requirement of termination upon the completion of specific activities.

5. **Initial Contribution of Partners** - This is one of the most critical parts of a partnership agreement, particularly where contributions are not all in the form of cash, paid in advance. The agreement should probably state the amount of the contribution to be made; the date the

contribution(s) are to be made to the partnership; the form of contribution(s); the agreed-upon valuation of contributions other than cash (which is especially important for a variety of tax purposes, and probably should be discussed with the partners' tax advisors); any interest to be paid on contributions prior to formation of the partnership if contributions are made in advance; any adjustments that may be made in contributions required from each partner; any provision for loans to the partnership; the effect of failure to contribute; and in the event that one or more partners are to contribute services, the value of such services, the value of any capital interest being acquired, and the consequences of failure of performance. (There are very intricate tax consequences associated with contribution of services to partnerships in exchange for capital interests, and these issues should be discussed in advance with the partners' tax advisors).

6. **Additional Contribution Requirements** - If additional contributions may be required, the agreement should address the procedure for establishing the necessity and amount of any such required amounts, as well as the timing and form of any such additional contributions. The agreement should also cover the notification procedures associated with any requirement for additional contribution; the apportionment of any additional contribution among partners; a provision for redistribution of partnership interests for non-proportional contributions, and procedures if a partner fails to make required contributions.

7. **Assets of Partnership** - A partnership agreement may seek to identify assets, to set forth rules governing how title to assets is to be held, provide an agreed-upon valuation of or method for valuation of assets, establish control over assets and accountability for partnership assets, and list any rules about the distribution of assets.

8. **Liability -** A partnership agreement may cover the topic of the partners' liability to one another or even the partners' liability to third parties, although these provisions will not be able to adversely affect the rights of third parties.

9. **Allocation of Profits and Losses** - Every partnership should agree upon how profits and losses are to be divided among the partners. If any partner is guaranteed a share of profits, this should be specified. If salaries are to be paid, this should be addressed, particularly if a services-only partner is to receive a salary but is not supposed to share in losses above the value of those services. Any special allocation of losses (that is, an allocation of any item of loss or any deduction to a partner in a proportion which differs from the ordinary interest of that partner) will have to comply with rigorous requirements imposed by the Internal Revenue Code if it is to be respected for tax purposes. Profit and loss allocations should therefore also be considered by a tax advisor.

10. **Distribution of Profits** - This is not the same as the "allocation" of profits. Profits are allocated for tax purposes in the year the amounts are earned. This is true even if the partners do not see a penny of those earnings during the year in which they are earned and have no expectation of a pay-out in the foreseeable future. When the pay-out does occur, it is called a distribution. The allocation is the taxable event; subsequent distributions are not themselves taxable. However, distributions in advance of the annual allocations may be taxable, which is why most partnership agreements provide for loans, advances or draws against anticipated earnings. This is also a tax-related concept that should be reviewed by a tax professional. In general, a partnership's distribution provisions should cover the schedule or procedures for making distributions; any requirement for establishing reserve funds for partnership expenses prior to distributions; any mandatory distributions; identification of persons with authority to

declare distributions; timing of distributions; any limitations on distribution of profits, and advances or draws made in anticipation of distributions.

11. **Duties of Partners -** A partnership agreement may include a recital of specific responsibilities imposed on partners or the amount of time required of each partner. If partners are authorized to or prohibited from engaging in outside or competing activities, this should also be specified. Especially under the RUPA, this provision may seek to limit or expand the partners' fiduciary duties, such as the duty of care.[104] Such provisions may also include any partnership employee policies, contractual rights and limitations, and the right to or ownership of patents and trade secrets developed in the course of partnership business.

12. **Compensation and Benefits for Partners** - The partners should agree on any salaries that are to be paid to partners and the partners' rights to vacations, holidays, retirement, and other benefits.

13. **Provisions for Expenses of Partners and Partnership** - It is common for the partners to agree upon and designate a depository for partnership funds. The partnership agreement may provide for a responsible party to control income and distribution. One or more partners or other persons may be authorized to negotiate loans and to arrange for their repayment. Alternatively, the agreement may specify a method and time for disbursing payment on indebtedness. Any limitations on indebtedness of partnership should be spelled out.

14. **Management and Control of Business** - If the partnership is to be managed by fewer than all of the partners, the agreement should designate the managing partners or other managers, as well as procedures for their removal and/or replacement. If there are multiple managers, the agreement may cover the division of functions between then. It may also have provisions for partnership business meetings, and spell out any requirements for keeping records of management and control decisions. Any policies that would restrict or limit the managers' authority should also be specified.

15. **Changes in Partners** - A partnership agreement should probably include requirements and procedures governing the admission of new partners and any requirements that may be imposed prior to the acceptance of additional or substitute partners. If there is to be a redistribution of assets upon such changes, the manner in which such redistribution is to occur should be agreed upon. Certain items should also be dealt with to cover the situation of a withdrawing partner. If the other partners are to have the right to expel a partner, this right needs to be in an agreement. The right of a partner to quit or retire should also be explicit. Any limitations and conditions upon voluntary withdrawal should be spelled out as well. The agreement should include provisions relative to the buy-out of a withdrawing partner's interests, including calculation and provision for payment of the buy-out price. The agreement may wish to specify whether and how goodwill is to be considered upon distribution of assets to a withdrawing partner. The agreement may also need to address any reorganization of partnership rights and duties that would be required upon withdrawal of a partner.

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104. Because fiduciary duties under the UPA are imposed by the courts rather than the statute, it is not clear whether partners are entitled to modify their obligations to the partnership or other partners in a partnership agreement.

16. **Death of a Partner** - This may be dealt with separately from voluntary acts of withdrawal. If so, the agreement may specify provisions relative to the purchase of the decedent partner's interest. The agreement should provide whether death results in dissolution or a presumed continuation of the partnership. It should also consider whether the estate should be allowed to act as partner, and if so, for how long. The agreement should also cover any decedents' rights to receive share of assets or additional income from the partnership.

11. **Sale or Purchase of Partnership Interest** - A partnership agreement should address any right of first refusal or option to purchase held by the remaining partners or other terms relating to the right of a partner to transfer his or her partnership interest. Any limitations on the purchaser of an economic interest should be spelled out, with the understanding that the UPA does not expressly allow such restrictions and the courts may not respect any purported restriction which it deems to be unreasonable. The agreement should also cover any required terms for the sale of partnership interests and the procedures to be followed in reorganizing the partnership following the sale.

12. **Arbitration of Disagreements** - Some dispute resolution mechanism may be desirable, especially in two-person or two-family partnerships where deadlock is possible.

13. **Dissolution and Winding Up** - Most partnership agreements include a listing of the conditions which will lead to dissolution of partnership. This may include events which trigger dissolution by operation of law. Agreements may also consider procedures and time for winding up business, although the statutes include fairly specific and reasonable procedures. If the partnership desires to establish a committee for winding up the partnership business, this should be spelled out in an agreement. Any compensation for committee members should be included in the agreement. Finally, the agreement may or may not cover distribution procedures, which are also fairly well covered in the statutes.

D. Limited Partnership

1. Business Law Status

In most states, limited partnerships are governed by a version of the Revised Uniform Limited Partnership Act, which is usually referred to as the RULPA. Although the RULPA may have been modified by the state legislatures in a variety of ways, there is a great deal of similarity in the way limited partnerships operate, regardless of the state of formation.[105] The information provided in this article tracks the provisions of the uniform act, recognizing that the law in any given jurisdiction may vary somewhat from the rules discussed here.

a. Formation

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105. The official version of the Revised Uniform Limited Partnership Act can be found in volume 6A the Uniform Laws Annotated. This document, however, refers solely to the sections of the uniform act, rather than giving the full official citation. NCCUSL is currently considering an updated version of RULPA, which will change some of the rules described here. Any such provisions would take effect only after a given state enacted the revisions.

A limited partnership is formed by filing a certificate of limited partnership with appropriate state officials.[106] Obviously, this means that an oral agreement will not be sufficient to create a limited partnership. However, the information required to be contained in a certificate of limited partnership is quite limited.[107] Typically, unless the parties wish to abide by the default rules contained in the relevant statutes, the bulk of the agreement between the partners in a limited partnership will be contained in a partnership agreement. The partnership agreement need not be in writing, although 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, there are nonetheless a fair number of cases dealing with the issue of what happens when these requirements are not complied with or are complied with only in part. In general, 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.[108]

Under the RULPA, a limited partnership is a partnership with at least one general partner and at least one limited partner.[109] A limited partnership is taxed as a partnership and subject to many of the same rules as general partnerships. The biggest distinctions between general and limited partnerships have to do with management rights and limited liability of the limited partners.

b. Management of a Limited Partnership

Management of a limited partnership is vested in the general partners.[110] Limited partners do not have management authority. They do, however, have a benefit that the general partners do not possess. Limited partners do not have the unlimited personal liability of general partners.[111] If, however, they assume control over the partnership's business and a third party assumes because of their actions that they are general partners, the limited partners will lose their limited liability as to such third party.[112]

In a change from the first Uniform Limited Partnership Act, the RULPA contains a detailed but non-exclusive list of activities which will not be deemed to amount to "participating in control."[113] Under

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106. RULPA § 201.

107. RULPA § 201(a).

108. *See, e.g*., Dwinell's Central Neon, v. Cosmopolitan Chinook Hotel, 21 Wash. App. 929, 587 P.2d 191 (1978).

109. RULPA § 101.

110. RULPA § 403.

111. RULPA § 303(a).

112. RULPA § 303(a).

113. RULPA § 303(b).

the terms of this provision, a limited partner will not risk losing the protections of limited liability solely by doing any one or more of the following:

(1) Being a contractor for or an agent of the limited partnership or of a general partner (including serving as an officer, director, or shareholder of a corporate 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, by voting or otherwise, on any of a number of specified matters which might 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.

The only other way for a limited partner to wind up with unlimited personal liability is to "knowingly permits his name to be used in the name of the limited partnership," in which 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.[114]

c. Persons Erroneously Believing Themselves to be Limited Partners

On the other hand, it is clearly possible for someone to believe that he or she is a limited partner when in fact he and she is not. This may occur either because no certificate of limited partnership was properly filed and therefore the limited partnership does not exist, or because the person in question was improperly omitted from the list of limited partners. In either event, the RULPA clearly spells out the consequences for someone who erroneously believes himself or herself to be a limited partner.

The RULPA provides that a person who makes a contribution to a business enterprise and "erroneously but in good faith" believes that he or she has become a limited partner may do one of two things to cut off his or her liability:

(1) The person in question can file an appropriate certificate of limited partnership or a certificate of amendment; or

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114. RULPA § 303(d). A limited partner may be liable for the value of any agreed-upon contribution, for debts as to which the limited partner acts as a surety or guarantor, and for debts arising out of the limited partner's personal misconduct. In addition, the veil of limited liability might be pierced, resulting in the imposition of personal liability on all participants, although there appear to be no reported cases holding a passive limited partner liable in this manner.

(2) The person may withdraw from future equity participation in the enterprise by executing and filing in the office of the Secretary of State a certificate declaring such withdrawal.[115]

Once this is done, there is no risk of liability as a general partner to future creditors, although any creditor who transacted business with the enterprise before the partner withdrew or filed the appropriate certificate can hold the partner liable, but only if the creditor "actually believed in good faith that the person was a general partner at the time of the transaction."[116]

d. Contrasting a Limited Partnership with a General Partnership

In addition, a number of other issues are handled somewhat differently in the statutory rules applicable to limited partnerships rather than general partnerships. First, a limited partnership can only be formed upon the filing of a written document which names the partners.[117] Second, the limited partnership must have at least one limited partner, as well as at least one general partner.[118] Third, unless the partners agree otherwise, profits and losses of a limited partnership are presumed to be allocated on the basis of the value of the contributions made by each partner rather than equally, as would be the case with a general partnership.[119] The RULPA also differs from the uniform partnership acts in that it expressly prohibits distributions that would render the partnership insolvent.[120] In addition, absent agreement to the contrary, while a general partner has the absolute right to withdraw from a limited partnership at any time, the RULPA requires a limited partner to give at least six months' written notice to each general partner before withdrawing.[121] Moreover, withdrawal of a limited partner does not trigger dissolution, and even withdrawal of a general partner does not necessarily mean that the partnership must dissolve.[122]

e. Dissolution and Termination

The dissolution and termination provisions of the RULPA are rather complicated. Under the terms of the statute and subject to the contrary agreement of the partners, a limited partnership may be judicially dissolved upon the petition of any partner "whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement." This is permissive, in the sense that a court is empowered to order dissolution rather than being required to do so.

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115. RULPA §304(a).

116. RULPA § 304(b).

117. RULPA § 201.

118. RULPA § 101(7).

119. RULPA § 503.

120. RULPA § 607. However, any fraudulent transfer law would probably operate in much the same way, so this distinction may be more apparent than real.

121. RULPA § 603.

122. RULPA § 801.

In addition, dissolution of a limited partnership occurs upon the happening of any of the following events:

i. The arrival of the time specified in the certificate of limited partnership or the happening of events specified in the partnership agreement.

ii. Written consent of all partners (general and limited, unless otherwise agreed).

iii. An event of withdrawal of a general partner, unless a provision of the partnership agreement permits any remaining general partners to carry on the business and they do so, or within 90 days after dissolution all remaining partners agree in writing to continue the business and, if necessary or desired, add new general partners. Under the RULPA , the following events amount to withdrawal of a general partner:

(A) A general partner resigns, retires, or otherwise quits.
(B) A general partner assigns all of his, her or its interest in the partnership.
(C) A general partner is removed in accordance with the partnership agreement.
(D) Unless the partnership agreement provides otherwise, a general partner takes certain specified steps in the nature of voluntary bankruptcy; *e.g*., files a voluntary petition, seeks or consents to the appointment of a receiver.
(E) Unless the partnership agreement provides otherwise, 120 days after an involuntary bankruptcy proceeding is filed against a general partner, unless it has been dismissed, or 90 days after a trustee or custodian is appointed without the general partner's consent.
(F) The death of, or the entry of a decree of incompetency concerning, a general partner who is a natural person.
(G) The termination of a trust if the general partner is a general partner because it is trustee of that trust.
(H) The dissolution and commencement of winding up of a general partner that is a separate partnership.
(I) The filing of a certificate of dissolution or equivalent action by a corporate general partner or the revocation of its charter.
(J) The distribution of an estate's interest in the partnership if the estate is a general partner.

As the RULPA makes clear, 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.

With regard to the process of dissolution, unless the partners have managed to avoid winding up by electing to avoid the dissolution as provided in the statute or partnership agreement, the partnership’s business and affaIrs must be wound up upon 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.[123] Under the RULPA, the partners may

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123. RULPA § 803.

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.

When one considers the rules applicable to liquidating distributions, it is apparent that the drafters of the RULPA have attempted to adopt default rules that will coincide with the expectations of most persons. Initially, the RULPA is clear that partners, both general and limited, may lend funds to and transact business with a limited partnership on the same basis as third parties. In addition, the priority of payment is relatively simple and approximates what most persons would likely expect. Under normal circumstances, the payout is in the following order of priority:

i. To creditors, including partners who are creditors other than for distributions required under the partnership agreement but not yet made.

ii. Except as provided in the partnership agreement, to partners for distributions required in the partnership agreement but not yet made.

iii. Except as provided in the partnership agreement, to partners first to return capital contributions with any remaining amounts distributed according to how interim distributions are shared.

This approach pays off creditors first, including partner- creditors, and then returns all other amounts to the partners as they may agree, making no distinction between general partners and limited partners. These amounts are not called "liabilities," which should avoid the possible obligation of general partners to make up any deficit.

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.

2. Tax Status

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.)[124] With this exception, however, it is likely that the vast majority of limited partnerships will choose partnership tax status. 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.

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.

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124. I.R.C. § 7704.

The Internal Revenue Code imposes a tax on the self-employment income of every individual in order to fund the nation's social security programs.[125] The Code also defines self-employment income as net earnings from self-employment less certain adjustments.[126] Net earnings from self-employment include the gross income earned by an individual from a trade or business conducted by the individual, less deductions attributable to the trade or business, plus the individual's distributable share of income or loss , with certain other adjustments.[127] However, "there shall be excluded [from net earnings from self-employment] the distributive share of any income or loss of a limited partner, as such, other than guaranteed payments[128] . . . to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services."[129]

Under these rules, payments to a limited partner are not subject to the 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. The distributive shares received as a general partner are treated as self-employment income and subject to employment taxes, and if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would be self-employment income.

Unless the limited partner has some particular interest in being covered by the social security system (which requires payment of a significant level of self-employment taxes), it will be in the interests of the partner to receive payments as distributions other than in the form of guaranteed payments for services. The Code clearly allows this.

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.[130] This can be an important consideration when estate planning is one of the motivations for forming a business into which to place farming assets.

3. Continued Viability of the Limited Partnership

At one point in time, the limited partnership was a very important option for many businesses. It allowed for centralized management (in the hands of the general partners), limited liability for the passive investors (the limited partners), and partnership taxation. Its most significant drawback was that the general partners, in exchange for the exclusive power to manage the business enterprise, also assumed unlimited personal liability.

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125. I.R.C. § 1401.

126. I.R.C.§ 1402(b).

127. I.R.C. § 1402(a).

128. Guaranteed payments are defined in I.R.C. § 707(c).

129. I.R.C.§ 1402(a)(13).

130. I.R.C.§ .

There are now other forms of business that will often better achieve the primary advantages once available only with the limited partnership form of business. The LLC in particular allows greater flexibility in achieving limited liability for all participants and tailoring the management structure to the desires of business participants. Moreover, unless a specific election is made, the LLC will be taxed as a partnership despite offering the advantages of limited liability and centralized management (to the extent desired).

The remaining reasons for choosing a limited partnership over the LLC are: (1) familiarity with the limited partnership form of business, particularly where the limited partnership in question can elect to become an LLLP (limited liability limited partnership) and thus give the general partner some protection against unlimited personal liability; (2) ease of understanding and application of partnership tax rules, particularly where the limited partners want to classify their share of income as something other than employment income; (3) accountants may prefer the limited partnership form; (4) the business is already set up as a limited partnership and changing would be inconvenient; (5) expense of formation, since custom-drafting LLC documents is often more expensive than drafting a "standard" partnership agreement for a limited partnership; and (6) estate planning considerations.

Recent searches of business filings reveal a relatively small number of new limited partnerships but a significant volume of LLLP filings in those jurisdictions where such filings are permitted. For this reason, if no other, it is important to consider the rules applicable to limited partnerships, since for the most part these rules will also govern LLLPs.

E. Limited Liability Partnerships

1. Business Law Status

One of the two newest forms of business entity is the limited liability partnership (LLP). The other is the limited liability limited partnership or LLLP, discussed below. All 50 states plus the District of Columbia have enacted LLP legislation, with Wyoming being the last state to do so. Because there was no uniform or model LLP Act when most of these state statutes were enacted, and because there is substantial variation from state to state, the following description of LLPs is even more general in nature than the descriptions of the other available forms of business enterprise discussed in this article. For persons wishing to research the law applicable to LLPs in a given state, the statues typically appear in the form of amendments to state general partnership laws.

In essence, an LLP is a general partnership where all partners have limited liability as to certain of the partnership's debts. Except for a very few special provisions, it is subject to the same rules as a general partnership.

a. Formation

One difference between an LLP and a general partnership is the way in which this form of business is created. As discussed previously,[131] no special formalities are required to form a general partnership. Certainly there is no requirement for a written agreement or filed document. On the other hand, an LLP can only be formed by having a general partnership file an application with the appropriate state officials (which means that it is impossible to form an LLP solely with an oral

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131. *See supra* part C.1. of this article..

agreement). The form which is to be filed typically requires very little information and is akin to the certificate of limited partnership for a limited partnership or articles of incorporation for a corporation. Generally, the document must include the name of the LLP, a registered agent and office address for service of process, and often a general statement that the partnership in question is electing LLP status. Under some state laws, the names of the general partners must also be included. Additional information may also be required under the statutes of any given state.

In some states, the registration must be renewed annually, although most state statutes no longer have an annual registration requirement. In states where annual registration is required, the statute typically provides that the registration as an LLP has a duration of a single year, and a new filing (with additional fees) is required each year. The effect of failure to renew varies from state to state, with some states specifically providing that a failure to renew in a timely fashion will not extinguish the limitation on liability until the Secretary of State or other official notifies the LLP that the registration is expiring. Other states provide that even a late renewal, so long as it is within specified time limits, retroactively reinstates the partnership's status as an LLP. Still other statutes with a renewal requirement are silent on the question of the effect of failure to renew in a timely fashion. Possibly as a result of the potentially disastrous effects of an accidental lapse in registration, at least from the individual partners' perspectives, the trend is clearly towards abandoning an annual renewal requirement.

Filing fees also vary dramatically from jurisdiction to jurisdiction. Some cases involve a flat fee, while in other states the fee imposed depends on the number of partners to be shielded from personal liability. In those jurisdictions with a renewal requirement, the entire filing fee is typically due with each renewal, making this a potentially significant source of state revenue and helping to explain why some states continue to require annual renewals.

In some states there are minimum insurance or financial responsibility provisions in the statute. These states impose a statutory requirement that each LLP maintain insurance covering certain obligations in an amount between $100,000 to $1,000,000. The statutes differ as to whether the LLP has the option of maintaining these amounts in a segregated account rather than obtaining outside coverage. Probably because of the impossibility of finding a single minimum insurance requirement that is appropriate for all LLPs, fewer and fewer states are retaining their insurance requirements.

b. Limitation on Liability of General Partners

The primary benefit of LLP status is another difference between general partnerships and LLPs. This benefit is that partners in LLPs have no personal liability for certain debts of the entity. The reason for hedging on the description of limited liability in an LLP is that there are two general models of liability in LLPs, and the states are split on the amount of protection from personal liability offered to general partners in such an enterprise.

Early LLP statutes adopted a rule which provided that partners in an LLP would have no liability for obligations arising out of the misconduct of others. "Misconduct" is variously described in the state statutes. Originally, the limitation on personal liability was limited to debts arising out of tortious malfeasance or misconduct by others, as the original LLP statute was designed particularly to protect partners in professional partnerships from personal liability for the malpractice of others.[132] This was

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132. For a detailed description of the background to the original LLP statute, which was adopted in Texas in 1991, see Robert Hamilton, *Registered Limited Liability Partnerships: Present at the Birth*

quickly expanded to cover liability for the misconduct of others, whether or not sounding in contract or tort, when it was realized that clever plaintiffs' lawyers could avoid the scope of the original statutory language through the simple expedient of framing a complaint in terms of breach of a contractual duty. The statutes generally came to include a list of activities for which the protection against personal liability would exist. Often these statutes provide a limitation on liability arising out of the errors, omissions, negligence, incompetence, or malfeasance of others, sometimes specifically including willful or intentional misconduct. There is no provision in these statutes (which are commonly referred to as first generation or partial shield statutes) that would allow partners in LLPs to avoid personal liability for business debts incurred in the course of ordinary partnership operations.

On the other hand, some states, beginning with Minnesota and including such influential jurisdictions as New York, adopted a much broader limitation on personal liability for partners in LLPs. In these jurisdictions, the statutes (generally referred to as second generation or full shield statutes) provide that a partner in an LLP has no personal liability for debts of the partnership, regardless of how such debts arise. Further encouraging the proliferation of second generation statutes, when the National Conference of Commissioners on Uniform State Laws drafted amendments to the RUPA in 1996 to authorize the formation of LLPs, they elected to include full shield protection in the Uniform Partnership Act. Thus, as states adopt the RUPA, they are more likely to adopt full shield provisions as well.

There is one other potentially significant difference in the statutory language relating to the limitation of liability afforded to partners in LLPs. There are essentially three different ways in which states have addressed the issue of when a partner should be liable for the misconduct of others. This issue arises regardless of whether the state statute in question insulates partners from personal liability for ordinary business debts of the LLP (i.e., is a first or second generation statute), since the question of when partners will be liable for the malfeasance of others is completely independent of the question of whether there should be liability for contractual debts of the enterprise. The first of the three approaches is for the statute to provide that a partner will be liable for the misconduct of those under his or her direct supervision and control. This was clearly the approach taken by most of the early first generation statutes. The second possibility is to adopt an alternative verbal formulation addressing the liability of partners for the misconduct of others. The third option is to enact legislation which simply does not mention the liability for the misconduct of others.

Many LLP statutes include language which makes a general partner liable for the tortious misconduct of those under the partner's "direct supervision and control." This language has appeared in LLP statutes in Arizona, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Virginia, Washington, and West Virginia.[133] Some of these states also imposed additional requirements in order for the "direct

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(Nearly), 66 U COLO. L. REV. 1065 (1995).

133. *See, e.g*., Ariz. Rev. Stat. Ann. § 29-215 (1995); Conn. Gen. Stat. § 34-53 (1995); Del. Code Ann. tit. 6 § 1515 (1994); Fla. Stat. ch. 620.782 (1996); Idaho Code § 53-315 (1995); Ill. Ann. Stat. ch. 805 para. 15 (Smith-Hurd 1995); Iowa Code § 486.15 (1995); Kan. Stat. Ann. § 56-315 (1994); Mich. Comp. Laws § 449.46 (1995); Mo. Rev. Stat. § 38.150 (1996); Neb. Rev. Stat. § 67-315 (1996); N.H. Rev. stat. Ann. § 212:5 (1996); Nev. Rev. Stat. § 87.150.2 (1996); N.J. Rev. Stat. § 42:1-15 (1995); N.M. Stat. Ann. § 54-1-15 (1995); N.Y. Partnership Law art. 3 § 26 (1995); Ohio Rev. Code Ann. § 1775.14 (1995); Or. Rev. Stat. Ann. § 68.270 (Michie Supp. 1996); 15 Pa. Cons. Stat. § 8204 (1995); R. I. Gen. Laws § 7-12-26 (1996); S.C. Code Ann. § 33-41-370 (Law. Co-op. Supp. 1994); S.D. Codified Laws § 48-2-15 (1995); Tenn.

supervision and control" language to apply. For example, the Kansas statute provided that the limitation of liability in an LLP does not extend to liability for misconduct of another if the partner was exercising "direct supervision and control at the time the negligence, malpractice, wrongful acts and omissions or misconduct occurred."[134] Similarly, the Virginia statute required that the "direct supervision and control" be in "the specific activity in which the negligence, malpractice, wrongful acts or misconduct occurred."[135] The New York LLP Act provided that liability will exist if a partner was exercising "direct supervision and control while rendering professional services . . . ."[136]

A few statutes use formulations that make the question of when a partner in an LLP will have personal liability for the acts of another turn on something other than "direct supervision and control." The District of Columbia, Maryland, North Carolina, and Texas LLP Acts all fit into this category. The Maryland statute says that a partner will have personal liability for the acts of another "if the partner is negligent in appointing, directly supervising, or cooperating with the other . . . ."[137] The North Carolina statute says that a partner is insulated from personal liability for the misconduct of another "unless the first partner was directly involved in the specific activity . . . ."[138] The District of Columbia and Texas, upon which the District of Columbia clearly relied in drafting its statute, have the most complicated statutory provisions. Statutes in these two states provide for limited liability:

> unless the first partner:
> (a) was directly involved in the specific activity in which the errors, omissions, negligence incompetence, or malfeasance were committed by the other partner or representative; or
> (b) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance of the other partner or representative at the time of occurrence.[139]

A third group of state statutes omit any reference to potential liability for the acts of others. These states include California, Colorado, Georgia, Indiana, Kentucky, Louisiana, Minnesota, North Dakota, and Utah.[140] This does not mean that partners in an LLP in such jurisdictions will have no

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Code Ann. § 61-1-114 (1996); Va. Code Ann. § 50-15 (1995); Wash. Rev. Code § 25.04.730 (1996); W. Va. Code § 47B-3-6 (1996).

134. Kan. Stat. Ann. § 56-315 (1994).

135. Va. Code Ann. § 50-15 (1995).

136. N.Y. Partnership Law art. 3 § 26 (1995).

137. Md. Code Ann. § 9-307(c) (1996).

138. N.C. Gen. Stat. § 59-45 (1994).

139. D.C. Code Ann. § 41-146 (Supp. 1995); Tex. Rev. Civ. Stat. Ann. art. 6132b § 15 (1995).

140. Cal. Corp. Code § 151015 (1996); Colo. Rev. Stat. § 7-60-115 (1996); Ga. Code Ann. § 14-18-15 (1995); Ind. Code § 23-4-1-15 (1996); Ky. Rev. Stat. Ann. § 362.220 (Baldwin 1995); Ind. Code § 23-4-1-15 (1996); La. Rev. Stat. Ann. § 3431 (1995); Minn. Stat. § 323.14 (1995) (as amended by 1995 Minn. Sess. Law Serv. ch. 58 (S.F. 1042) (West); Utah Code Ann. § 48-1-12 (1995).

liability for the misconduct of others. Certainly, if a partner has a duty to supervise or control another person and is personally negligent in performing those supervisory functions, liability should exist, regardless of a specific statutory provision in the LLP Act discussing personal liability for the acts of others. The exact extent of personal liability for partners in LLPs is pure speculation, however, since there are currently no reported decisions dealing with this issue in the context of LLPs under any of the various statutory models.

In addition, none of the existing statutory models offer much guidance about what was intended as to precisely when a partner should be personally liable for the misconduct of others in the partnership. For example, LLP statutes that use the phrase "direct supervision and control" offer no definition of this language. In fact, none of the state LLP acts include any explanation of how to interpret the applicable statutory language concerning when a partner in an LLP will be liable for the acts of another.[141]

c. Comparing an LLP to a General Partnership

The foregoing discussion points out only four primary differences between LLPs and general partnerships: they are formed in different ways; they may have different requirements concerning insurance or financial responsibility; specific steps may need to be taken in order to maintain LLP status; and the liability of general partners is significantly different.

Aside from these differences, the statutory rules applicable to general partnerships also apply to LLPs. Thus, all partners will have equal management authority unless otherwise agreed, and even with agreement to the contrary, all partners retain apparent authority to bind the partnership by acts which are apparently carrying on the usual business of the partnership. The default rule under both the UPA and the RUPA is that all partners have equal rights to share in profits and losses of the enterprise. Under the UPA, withdrawal of any partner triggers dissolution of the partnership and only if the withdrawal is made wrongful by agreement will the remaining partners have the right to continue the business. Under the RUPA, withdrawal of a partner triggers dissolution and winding up unless the parties have agreed to a particular term or undertaking for the business, have otherwise agreed that the partners have no right to withdraw, or the remaining partners make a timely election to continue the business.[142]

As a practical matter, perhaps the most significant disadvantage to the LLP as compared to the general partnership form of business is the relative novelty and unfamiliarity of the LLP. This means that relatively little has been written about them, although this is changing as the LLP gains in popularity. However, in most states, there are still relatively few guide books or other resources to help people become familiar with this form of business organization.

d. Choice of Law Problems

Another problem associated with the fact that LLPs are so new is the uncertainty about which state's law will apply. This matters because of the significant variation from state to state in terms of

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141. For a more detailed discussion of what the phrase “direct supervision and control” might mean in this context, see Carol Goforth, *Limiting the Liability of General Partners in LLPs: An Analysis of Statutory Alternatives*, 75 OR. L. REV. 1139 (1997).

142. Again, for a more detailed examination of the rules applicable to general partnerships under the UPA or RUPA, see *infra* part D.1. of this article..

requirements for formation of LLPs and the extent of the partners' protection against personal liability for partnership debts. Although more and more states appear to be electing the second generation approach, at the current time the states are clearly divided between the two models of liability for partners in LLPs. What happens when an LLP conducts business in a state with a different liability model than in the LLPs' state of formation?

Obviously, there is unlikely to be any problem if the state of formation offers only limited protection against personal liability (i.e., is a first generation state). In this case, the second state and the parties located there are unlikely to be unhappy with the prospect of greater personal liability for the partners, and the partners are unlikely to be in a position to complain since they have formed a business under those terms. However, if an LLP is formed in a state that offers full shield protection, and then conducts business in a state that does not recognize the full scope of such protections for domestic LLPs, there may be room for disagreement in the event of a breach of contract or other contractual default.

The liability in question would have to be something other than that arising out of misconduct or malpractice, because under either type of LLP statute, liability for this type of debt would be limited. But what if the LLP that is formed in a second generation state enters into a contract with a party from a state that has only a first generation LLP statute? Suppose further that the LLP defaults. Are the partners personally liable? Under the laws applicable in the state where the LLP was formed, the partners would not be liable. On the other hand, under the laws applicable in the state where the creditor is located, partners in an LLP are liable for such debts.

Ideally, the creditor would take care of this potential problem in advance by insisting on personal guarantees from the partners if personal liability of the partners is important. However, if the creditor is in a jurisdiction where partners have always had and continue to have such personal liability as a matter of law, this may simply not occur to them. What then?

Two Rhode Island practitioners, writing about this issue in their state bar journal, recently opined as follows:

> LLPs which propose to do business in many states, or more dramatically in every state, could be subjected to a permanent identity crisis and more importantly could be left guessing on a case-by-case basis as to whether or not the partners might be subjected to personal liability, to statutory penalties and sanctions for unauthorized business transactions or unauthorized practice, or to both.[143]

There is very little authority on this issue. An LLP doing business in multiple jurisdictions will be well advised to check carefully with legal advisors in each such state, because many states have statutory provisions specifically applicable to foreign LLPs wishing to do business in the state.

2. Tax Status

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143. Stephen M. Brusini and Stephen D. Zubiago , *Crossing the Border – The Use of Limited Liability Partnerships in Interstate Commerce*, 47 R.I. B.J. 9 (Ap. 1999).

Because an LLP is really only a general partnership that has elected special status for its general partners, LLPs should be taxed just like general partnerships.[144] That discussion will not be repeated here.

F. Limited Liability Limited Partnerships

1. Business Law Status

a. Statutory Authorization for LLLPs

A minority of states have also adopted statutes which expressly authorize the formation of limited liability limited partnerships (LLLPs).[145] An LLLP or limited liability limited partnership is a limited partnership where the general partner has the same protections against personal liability that a general partner in an LLP possesses. In states that have an LLLP statute, this form of business enterprise is clearly authorized. In other states, the authority is less than clear.

The question is whether other states have authorized the formation of LLLPs by implication in their LLP statutes. In some states where the LLP legislation takes the form of an amendment to existing partnership law, an argument can and has been made that statutory references to “partnership" law includes limited partnership law, and therefore by implication, partners in limited partnerships in such states ought to be able to gain the protections from unlimited personal liability provided in the LLP legislation.

Prior to the RUPA, there were explicit linkage provisions in both the uniform limited and general partnership acts, and because these statutes had been so widely adopted, the same linkages appeared in the laws of most states. The UPA states that a limited partnership is not a partnership but provides that the UPA "shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith."[146] the RULPA similarly defines a limited partnership as a "partnership,"[147] and further specifies that "[i]n any case not provided for in this [Act], the provisions of the [UPA] govern.[148] Using these cross-references, it is possible to make the argument that since a general partner in a general partnership is entitled to limited liability, general partners in a limited partnership should also be entitled to the limited liability if an appropriate election is made. This

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144. *See supra* part C.2. of this article for further discussion of this issue.

145. *See, e.g*., Ariz. Rev. Stat. Ann. § 29-367; Ark. Code Ann. § 4-42-706; Colo. Rev. Stat. Ann. § 7-62-1104; 6 Del. Code § 17-214; West’s Fla. Stat. Ann. § 620.187; Iowa Code Ann. § 4878.1301; Md Code, Corps & Assoc., § 10-805; Minn. Stat. Ann. § 322A.88; Vernon’s Ann. Mo. Stat. § 358.510; West’s N.C. Gen. Stat. Ann. § 59-210; N.D. Cent. Code §§ 45-23-01 to -08; S.D. Cod. Laws § 48-7-1106; Tex. Civ. Stat. Ann. 6132a-1 sec. 2.14; Va. Code Ann. § 50-73.78.

146. UPA § 6(2).

147. RULPA § 101(7).

148. RULPA § 1105.

argument is much harder, and perhaps impossible, under the RUPA, which not only does not explicitly provide for linkage but also defines "partnership" to exclude limited partnerships.[149]

Until there is a judicial determination in each state that LLP legislation implicitly authorizes LLLPs, the legality of LLLPs is certain only in those states which have statutes expressly addressing this form of entity.

b. Characteristics of the LLLP

Assuming that the LLLP is authorized or at least recognized in a given jurisdiction, what are the characteristics of this form of business enterprise? With the exception of registration requirements, the requirement that every LLLP contain some indication in its name that it is an LLLP, and the change in the personal liability of the general partner(s), an LLLP is virtually indistinguishable from a limited partnership under state law.

In fact, the only significant differences are the same differences that distinguish between a general partnership and an LLP: the new provisions relating to filing of a registration statement and renewals thereof, insurance requirements, and limited liability for general partners.[150] Obviously, the name of an LLLP would be sightly different from the name of an LLP as well. In those states where the LLLP is expressly recognized, the statutes will set forth the requirements for filing an election to register as an LLLP. For the most part, those provisions track the applicable requirements of registering as an LLP, although the name of the LLLP is subject to slightly different requirements and limitations.

With regard to the effect of electing LLLP status, a limited partner in a limited partnership is already insulated against personal liability for debts of the partnership (unless the limited partner participates excessively in the control of the partnership), but a limited partnership must also have at least one general partner. Therefore, the advantage of being an LLLP is that the general partner(s) of the limited partnership will be insulated from personal liability, either arising out of the tortious misconduct of others or from any entity level debt, depending on the statutory language used. Other than that, an LLLP is much like an LLP, except that the basic structure is that of a limited partnership rather than a general partnership.

There is one other issue which will potentially apply differently to LLLPs and LLPs: how will states lacking an LLLP statute react to this form of business? As discussed previously, there are potential issues which arise in connection with LLPs that operate beyond the borders of a given state simply because the rules applicable to the liability of partners in those ventures may differ from place to place. However, every state at least recognizes that basic form of business. This is not the case with the LLLP. Some states do not provide for LLLPs at all, so there is at least the potential issue of how an LLLP will be treated if it does business with or interacts with persons from other states, particularly those that do not have such a form of business.

Principles of comity and the full faith and credit clause of the United States Constitution provide some support for the notion that an election among parties to a partnership agreement to be governed

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149. RUPA § 101(4).

150. For a discussion of the differences between general partnerships and LLPs, see *supra* part E.1. of this article..

by the laws of one state should be respected in another state. In the context of the LLLP, this would carry with it the benefits of the limitation on a partner's liability contemplated by the election of LLLP status. However, the ordinary rules applicable to any conflict of law issue might or might not support the rule of law of one state over that of another, lending to the considerable uncertainty which is associated with this form of business, at least in situations where interstate operations are contemplated.

2. Tax Status

LLLPs should be taxed in the same way as limited partnerships.[151]

3. Is the LLLP a Viable Alternative?

Relatively few states have adopted LLLP statutes, potentially signaling a belief on the part of some that this form of enterprise is unnecessary or undesirable. There is also considerable uncertainty surrounding this form of enterprise, given that it is not at all clear that all states will recognize a limitation on liability established by a statute which has no parallel in the state in question. Given these two facts, it is certainly worth considering whether there are reasons for businesses to choose this option when organizing their business.

One potential advantage relates to the familiarity factor as a matter of state law. Because the LLLP is basically grafted onto the limited partnership statute, most of the rules applicable to this form of enterprise have been around for some time. While this statement used to be equally applicable to LLPs, the spread of the RUPA makes this less true now than in recent history because the RUPA has made some sweeping changes in the law applicable to general partnerships. A similar revision to the RULPA is currently underway but has not yet influenced state law. Thus, the LLLP is a very familiar form of business that offers all owners at least some protection against personal liability. In second generation states with LLLP statutes, this is full shield protection and may make the LLLP particularly attractive, especially for businesses that plan to operate only in-state. The LLC has been in existence for a far shorter period of time, and because of the considerable variation between state laws, there is far less written to guide practitioners.

The familiarity factor is likely to be the most significant for existing businesses with a history of operating as a limited partnership, especially those that wish to retain the same structure and organization, and even the collegiality implicit in having "partners." However, as the LLC becomes more common and better understood, and as RUPA becomes more entrenched, the perceived advantages offered because the limited partnership form is more familiar should diminish.

The familiarity factor also applies when the treatment of LLLPs under the Internal Revenue Code is compared with the treatment of LLCs under those same rules and regulations. The I.R.S. has had a number of years in which to consider the circumstances under which businesses organized under state partnership statutes will be classified as partnerships for federal tax purposes rather than as associations taxable as corporations. In contrast, LLCs are a relatively new form of business enterprise, and there are a number of issues relating to the taxation of LLCs that have not been fully addressed. There are two such rules which may favor the choice of LLLP. One relates to the requirements for discounts on valuation, most useful in the estate planning context. These rules are far more developed in the context of limited partnerships than for LLCs. Similarly, the limited

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151. *See supra* part D.2. of this article..

partnership and, thus the LLLP, offers greater flexibility in avoiding employment taxes on distributions to limited partners, because the applicability of the self-employment tax provisions to LLCs is still uncertain. Thus, the tax regulations and rulings, which are currently more complete for partnerships (and particularly limited partnerships) than for LLCs, provide one reason why an entity might prefer to be organized as an LLLP. However, as the I.R.S. has increased opportunities to consider LLCs and the application of its rules and regulations to such entities, this advantage is also likely to diminish.

In addition to these income tax consideration, when it comes to reducing the value of interests in a business for estate or gift tax purposes, the LLLP may be particularly attractive. Because limited partners have both limited rights to manage and limited rights to transfer their ownership interest, the I.R.S. currently recognizes and allows certain discounts to be applied when valuing such interests. This may be especially important where a business is being formed for estate planning purposes, since it may be possible to significantly reduce or even avoid estate and gift taxes by reducing the value of particular ownership interests.

There is also one other potential tax advantage to LLLPs as compared to LLCs, at least in certain states. Many states impose business taxes or franchise taxes on corporations and other forms of businesses that offer corporate characteristics such as limited liability. Many of these taxing statutes specifically exclude partnerships, and presumably LLLPs, from their ambit. Thus the avoidance of such state taxes may be another reason in favor of the LLLP format.

While this is not intended to be an all-inclusive listing of the potential advantages of LLLPs, this discussion should help explain why the LLLP is, in fact, utilized in those jurisdictions where it is recognized.

G. Conclusion To Part I

These materials focus only on the sole proprietorship, the general partnership, the limited liability partnership (LLP), the limited partnership, and the limited liability limited partnership (LLLP). Part II in this series will address the limited liability company (LLC) and the corporation.

These materials should make it clear that each of these forms of business offer some advantages and at least some disadvantages. In any given case, some of these options will not be available or will clearly be less desirable than other alternatives. Although the general partnership is more familiar than the LLP and the limited partnership more familiar than the LLLP, the limited liability enterprises are more likely to have advantages which outweigh this consideration in most situations. Thus, it is not surprising that a great many of the businesses being formed today are organized as LLPs, LLLPs, LLCs or corporations (which are still very popular).

Although these materials focus on the default rules under state law and the possible variations from those rules, when it actually comes to choosing and forming a business out of which to run an agricultural operation, there are likely to be a number of issues that go beyond what is technically possible under state law. The expense of formation or of customization should not be overlooked. Some of these forms of organization are likely to work well only if experienced legal counsel assists in the preparation of written documentation, and this could be costly. Moreover, there are tax and accounting considerations which may also be important in choosing an optimal format for an agricultural (or any other) enterprise.

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