RightRisk™

Risk Concepts

Limited Liability Partnership

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

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

A limited liability partnership (LLP) is a general partnership where all partners have limited liability as to other partner's debts and liabilities due to misconduct. Except for a very few special provisions, it is subject to the same rules as a general partnership. There are four primary differences between LLPs and general partnerships: (1) they are formed in different ways; (2) they may have different requirements concerning insurance or financial responsibility; (3) specific steps may need to be taken in order to maintain LLP status; and (4) the liability of general partners is significantly different. Aside from these differences, the statutory rules applicable to general partnerships also apply to LLPs.

All partners 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 Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) is that all

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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.

Formation

Unlike a general partnership, an LLP can only be formed by having a general partnership file an application with the appropriate state officials. 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. 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 states with a renewal requirement are silent on the question of the effect of failure to renew in a timely fashion.

Some states have minimum insurance or financial responsibility provisions in the statute. The statutes differ as to whether the LLP has the option of maintaining these amounts in a segregated account rather than obtaining outside coverage.

Operational Attributes

A limited liability partnership generally operates like a general partnership. All partners have equal management authority unless otherwise agreed upon. Absent any agreement by the partners to the contrary, the UPA and RUPA stipulate that all partners are to share equally in the profits and losses of the business.

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

There is significant variation among states as to the requirement for LLPs to renew their registrations. Further, some states specifically provide 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.

Liability

The primary benefit of LLP status is that partners in LLPs have no personal liability for certain debts of the entity. However, states are divided about the amount of protection from personal liability offered to general partners in such an enterprise.

Some states provide rules that grant liability protection for obligations caused by the misconduct of others. The statutes in these states generally contain a list of activities for which the protection against personal liability exist. However, there is commonly no provision in these state statutes (commonly called "first generation" or "partial shield" statutes) that would allow partners in LLPs to avoid personal liability for business debts incurred in the ordinary course of partnership business.

Other states provide rules that limit the liability of partners in an LLP. The statutes in these states (commonly called "second generation" or "full shield" statutes) generally provide that a partner in an LLP has no personal liability for debts of the partnership, regardless of how such debts arise.

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." Some of these states also imposed additional requirements in order for the "direct supervision and control" language to apply. There are still other states that make no references to the potential liability for the acts of others.

Tax Attributes

An LLP is taxed as a partnership and subject to many of the same rules as general partnerships. Unless the partners agree otherwise, profits and losses of an LLP are presumed to be allocated on the basis of the value of the contributions made by each partner rather than equally as with a general partnership.

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

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

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

Transfers of Ownership (Succession and Estate Planning)

A partner in any partnership is generally not entitled to transfer all of the attributes of ownership to any other person, absent the unanimous consent of all other partners. The default rule under UPA and RUPA is that a partner can transfer his or her rights to profits and distributions

but not any other rights traditionally vested in partners. The person receiving the economic rights would have only very limited rights and no ownership nor management rights.

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

Dissolution

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

Dissolution begins when a partner voluntarily withdraws from the partnership (e.g. retirement or announces an intent to withdraw) or involuntarily (e.g. death, incapacity, or removal by the other partners). Under the UPA, a limited liability partnership automatically begins dissolving when a partner ceases to be associated with the partnership unless the partnership agreement provides for it or the dissolution is wrongful (which means either that the partner's withdrawal is in contravention of an express provision in the partnership agreement or that it occurred before the expiration of a definite term or the completion of a particular undertaking for which the partnership was formed). The revised statutes (RUPA) provide that either dissolution may be followed by winding up the business or the business may be continued and the withdrawing partner paid off.

Summary

A limited liability partnership (LLP) is a relatively new form of business entity. In essence, an LLP is a general partnership where all partners have limited liability as to other partner's debts and liabilities due to misconduct. Except for a very few special provisions, it is subject to the same rules as a general partnership.

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

Resources

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

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

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