



Business Organizations Reading Room

The Limited Partnerships

Rusty Rumley
Staff Attorney

Introduction

The limited partnership structure is created by two or more people or businesses that file the proper paperwork with the state in which they wish to form. Unlike a sole proprietorship or general partnership, there are formalities that must be followed in order to create this form of business structure. The most unique feature of this structure is the two separate classes of partners that must exist in order to create the business. To be valid the limited partnership must consist of one or more general partners and one or more limited partners. The liability protection afforded by the partnership is exactly as the titles of the different classes of partners suggests. The limited partners enjoy limited liability and the general partners are generally held to be personally liable for the actions and debts of the limited partnership. This characteristic makes the limited partnership a useful business structure for partnerships where some or most of the partners wish to invest in the business without the exposure to personal liability, but do not want the tax burden associated with the corporate business structure.

Formation

The limited partnership is created by filing a certificate of limited partnership with the state agency in charge of registering new businesses. All states have adopted some form of model rules for partnerships that function as the default rules; however the partners can agree to adopt different rules through a partnership agreement. Regardless, the formalities for creating a limited partnership must be followed. The failure to follow the necessary requirements may result in either no business structure at all or the judicial creation of a general partnership with all partners being subject to general liability. The agency in charge of registering and creating new business entities will also list the necessary requirements to correctly form a new limited partnership. A list of these agencies and their contact information may be found at the National Agricultural Law Center under [Forms and Filing Information: Business Organizations](#).

Liability

Similar to a general partnership, there must be two or more partners who have an ownership interest in the business. Unlike a general partnership, there are two types of ownership interests. To form a limited partnership, there at least one general partner and at least one limited partner.

Limited partners are only at risk of losing the assets that they have invested into the limited partnership while general partners are personally liable for the actions of the partnership in the same way as are partners in a general partnership. Any debts or civil liabilities created by lawsuits that the limited partnership cannot pay may be enforced against the general partners' personal assets. The fact that the general partner bears the personal risk associated with the operation of the business appears to be an unfair burden at first glance. However, this risk is typically offset somewhat by the fact that the general partner typically runs the day-to-day operation of the business. By definition, the limited partners may only exercise limited control over the business. In fact, if they are found to be too involved, a court may take away the veil of protection and treat them as a general partner. Limited partners typically have little or no control over the business operation and remain as passive investors. The debts incurred by the partnership and the potential civil lawsuits that may arise during the operation of the business are primarily under the control of the general partner, and as a result it is fitting that the general partner bears the associated risk.

Example: Suppose a grandmother wanted to help her grandson start a farming operation. She has \$5 million and 5 grandchildren who will be her beneficiaries when she passes away. She could give the grandson \$1 million, but that could cause a significant problem in her estate plan later on. One potential solution is to create a limited partnership structure. The grandson will run the farm and make of the business decisions while the grandmother will supply the money to get the farm started. They must first go and file the necessary paperwork with the state in which they want to form under with the grandson as the general partner and the grandmother as the limited partner. The grandmother will contribute money to the limited partnership (say she contributes the full \$1,000,000) and then let the grandson start farming. Any profits will be shared between the grandson and grandmother.

Unfortunately the farming operation does very poorly and creditors begin filing lawsuits to collect past due payments. As general partner the grandson may potentially lose everything he owns since he is personally responsible for the actions and debts of the limited partnership. The grandmother, who was only a limited partner, can only lose up to the amount that she contributed to the limited partnership which was \$1,000,000. By this point the money which the grandmother initially invested should be entirely used up. No further actions may be taken against the grandmother so long as she remained as a passive investor.

The limited partnership structure provides a substantial improvement over the general partnership structure, since the limited partners will not typically be responsible for the debts and actions of the general partners or the employees. However, there are some drawbacks to this business structure. There must be at least one general partner who faces personal liability for the debts and civil liabilities of the limited partnership. The limited partners enjoy the fact that they will not typically be held liable for the responsibilities of the limited partnership, but this comes with a price. In order for a court to recognize the limited liability of the limited partner they

must have no substantial role in the operation of the business. The general partner(s) will make the day to day operating decisions.

Tax Structure

The tax structure for the limited partnership is slightly different from that of the general partnership. The limited partnership qualifies for taxation as a general partnership in almost all circumstances and because the “pass through” taxation structure is one of the most advantageous structures, the vast majority of limited partnerships will elect for it. The “pass through” structure allows for the profits and losses of the partnership to be allocated to the partners based upon their ownership interests (although this may be modified if there are substantial economic reasons to do so).

The difference with the limited partnership tax structure is the payment of self-employment taxes. General partners are treated as sole proprietors and regular partners in a general partnership. This will typically require the payment of self-employment tax on earned income because they are engaged in the operation of the business. However, the differences arise with the limited partners. In order for a partner to be considered “limited” they must have little interaction in the running of the business. They typically function solely as an investor with only limited input on important strategic decisions. The limited partners more closely resemble shareholders in a corporation instead of partners. Because of this fact, the IRS will treat payments to a limited partner as a return on investment, unless the payments are in the form of a salary or payments for services rendered to the limited partnership. The avoidance of self-employment taxes is the other reason (besides liability protection) why limited partners are often better served to avoid participating in the day to day operations of the business.

Termination

Any number of events can potentially terminate a limited partnership. The reason for the uncertainty is that the default rules that each state have in place may be modified by a partnership agreement that can add, modify, or remove events that would normally result in the limited partnerships termination. Like all business structures the business can terminate on the written consent of all owners or a court may dissolve the business if there is a situation such as insolvency, waste of assets, or a deadlock within the business.

Most states also treat the loss of one general partner as a termination event; however this can be specifically modified and probably should be if the partnership is comprised of many members. If the limited partnership loses all of the general or limited partners than the business will terminate, unless there is a provision to allow either new partners to enter into the business or for some of the partners to switch to the other class.

Conclusion

The limited partnership is a relatively new business entity. Like many of the modern business structures the partners are required to file the requisite legal forms with the state agency in charge of registering new businesses. Mistakes made in creating the business entity may have

adverse effects on the limited partners of the business so care must be exercised in forming the limited partnership. Also the ability to protect some, but not all, of the partners is a unique trait of the limited partnership and is the primary reason why this form of business structure is not as popular as the limited liability company or corporation, both of which potentially offer protection to all of their owners. Regardless of the problems that face the partners of a limited partnership there are some benefits that the structure provides. It is simpler to operate than other corporate structures that allow small businesses to have investors and provide them with limited liability without the need to exercise corporate formalities. While the popularity of the limited partnership may be exceeded by the limited liability company it still remains as a legitimate choice for members that wish to create a new business or modify an existing one.