

OHIO LIMITED PARTNERSHIPS—BUSINESS USE AND EFFECT

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The authors discuss various aspects of operating as a limited partnership under the Ohio Uniform Limited Partnership Act including the requirements of formation, the ability of a corporation to be a limited partner, the rights and liabilities of partners, and the treatment of partnership interests as securities under state and federal law. Taxation of limited partnerships is explained with emphasis on those factors that distinguish a partnership from a corporation for income tax purposes and the relative advantages of being taxed as a partnership.

I. INTRODUCTION

On September 14, 1957, Ohio became one of the forty-four states¹ which have adopted the Uniform Limited Partnership Act.² Hence, prior to the preparation of this article the authors conducted a survey of the use of the limited partnership form of business both before and after the enactment of the Uniform Limited Partnership Act. The survey was conducted by requesting certain statistical information from the clerks of the courts of common pleas of the eighty-eight counties of Ohio, who are the repositories of certificates of limited partnership under the act.³ The survey results were inconclusive. Those clerks who responded, for the most part, indicated a total unfamiliarity with a limited partnership and many did not respond at all. It does appear, however, that limited partnerships have been used to some extent in the larger urban areas for a variety of types of business activities ranging from real estate to oil and gas ventures.

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¹ 8 Uniform Laws Annotated 7 (Supp. 1966).

² Ohio Rev. Code Ann. §§ 1781.01-.27 (Page 1964). However, the business organization of limited partnership has not been widely used in this State for reasons too numerous to explore in this article.

³ Ohio Rev. Code Ann. § 1781.02(A)(2) (Page 1964).

With Ohio's adoption in 1957 of the Uniform Limited Partnership Act and the needed clarification in 1960 of the important income tax rules concerning the taxation of limited partnerships, the limited partnership concept may become increasingly attractive in selected business circumstances. The limited partnership will be analyzed in two segments: state law and federal tax law.

II. THE OHIO LIMITED PARTNERSHIP ACT

Little has been written concerning the limited partnership in Ohio. The enactment of the Uniform Limited Partnership Act repealed earlier legislation which dated back to 1864 and which was based on the New York statutes. The act is essentially that proposed by the National Conference of Commissioners in 1916.⁴ There is only one reported case in Ohio which has considered the Uniform Limited Partnership Act since its enactment,⁵ although the act has been construed by other courts in the various jurisdictions which have adopted it.

In the simplest sense a limited partnership is a partnership under the Uniform Limited Partnership Act,⁶ with exclusive management and control coupled with unlimited liability in the general partner,⁷ and with limited liability in the limited partner.⁸ The definition of a limited partnership is contained in the act:

A limited partnership is a partnership formed by two or more persons under the provisions of Section 1781.02 of the Revised Code, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by obligations of the partnership.⁹

Although the term "limited partnership" has been used loosely by some courts to refer to joint ventures and other forms of associations,¹⁰ in Ohio the term should only mean a partnership formed under the Ohio Uniform Limited Partnership Act. By definition, any other voluntary association of persons is not a limited partnership. Ohio has also adopted a Limited Partnership Associations Act,¹¹ but this article will be concerned only with the limited partnership.

⁴ See Commissioners' Note to Uniform Limited Partnership Act, 8 Uniform Laws Annotated 2-5 (1922).

⁵ Cleveland Trust Co. v. Ingalls, 91 Ohio L. Abs. 70, 23 Ohio Op. 2d 124 (1963).

⁶ Ohio Rev. Code Ann. § 1781.02 (Page 1964).

⁷ Ohio Rev. Code Ann. § 1781.09 (Page 1964).

⁸ Ohio Rev. Code Ann. § 1781.01 (Page 1964).

⁹ Ohio Rev. Code Ann. § 1781.01 (Page 1964).

¹⁰ See, e.g., M. E. Trapp, Ass'd v. Tankersley, 200 Okla. 117, 191 P.2d 202 (1947).

¹¹ Ohio Rev. Code Ann. §§ 1783.01-.12 (Page 1964).

A. *Formation of Limited Partnership*

Two or more "persons" desiring to form the limited partnership must sign and swear to a certificate of limited partnership stating fourteen specific requirements under the statute.¹² The certificate must set forth the name of the partnership, its character of business, location of the principal place of business, the term for which the partnership is to exist, the names and residences of the general and limited partners, the amount and character of the contributions by the limited partners and the share of profits to be received by the limited partners. Certain statements must also be made as to the rights, if given, of a limited partner to substitute an assignee in his place, admissions of additional limited partners, the nature of priority between the limited partners, and continuation of the business by the general partner or partners upon the retirement, death or insanity of a general partner. Finally, the certificate must contain a statement as to the additional contributions, if any, agreed to be made by each limited partner, a statement of when the contribution of each limited partner is to be returned, and a statement of the right, if given, of a limited partner to demand and receive property other than cash in return for his contribution.¹³

The certificate must be filed for record in the office of the clerk of the court of common pleas in the county in which the principal place of business of the partnership is located. The statute specifically requires the clerk of the court of common pleas to endorse the date of filing of the certificate and to record and index the certificate in a separate book.¹⁴ If the partnership has places of business in several counties, the certificate must be filed for record in the office of the clerk of the court of common pleas in every such county.¹⁵

Prior to the enactment of the Uniform Limited Partnership Act, the courts had narrowly construed similar statutes dealing with the formalities of formation so that the limited partner encountered serious danger of becoming bound for partnership obligations unless there was full compliance with the statutory requirement as to filing the certificate. Strict judicial interpretation of the certificate requirements "deprived the existing provisions for limited partners of any practical usefulness."¹⁶ The Uniform Limited Partnership Act has

¹² Ohio Rev. Code Ann. § 1781.02 (Page 1964).

¹³ Ohio Rev. Code Ann. § 1781.02 (Page 1964).

¹⁴ The survey conducted by the authors indicated that apparently some counties in the state do not maintain a separate book of limited partnership filings.

¹⁵ Ohio Rev. Code Ann. § 1781.02 (Page 1962).

¹⁶ See 8 Uniform Laws Annotated 3 (1922) (Comm'rs' Note); *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930); *Van Ingen v. Whitman*, 62 N.Y. 513 (1875); *Madison County Bank v. Gould*, 5 Hill 309 (N.Y. Sup. Ct. 1843).

attempted to eliminate this problem by stating: "A limited partnership is formed if there has been substantial compliance in good faith with the requirements of division (A) of this section."¹⁷ In addition, the act provides that if a certificate contains a false statement, a party who suffers loss by reliance on such statement may hold liable any party to the certificate who knew the statement to be false at the time he signed the certificate or knew the statement to be false subsequent to the signing, subject to certain conditions specified in the act.¹⁸

B. Corporations as Partners

The act provides that two or more "persons" desiring to form a limited partnership shall file the required certificate.¹⁹ However, there is no separate definition within the Ohio Uniform Limited Partnership Act of "persons." This lack of explicit definition within the act may cause a problem for the practitioner forming a limited partnership in Ohio.

The question frequently raised by the client or practitioner is whether a corporation formed under the laws of the State of Ohio may become a partner, either general or limited, in a limited partnership in Ohio. A negative conclusion might well be reached, based upon an old general rule that a corporation may not become a general or a limited partner because it has no authority to share its corporate management with others. The old rule is usually justified by stating that the partnership relationship is not consistent with the traditional form of corporate management by officers or directors chosen by the stockholders, and to permit such an arrangement might result in subjecting the corporate assets to risks not contemplated by the investors at the time they acquired their corporate stock.²⁰

The rule that a corporation *without specific enabling charter provisions* may not enter into a partnership or a limited partnership either as a general or limited partner has been eroded substantially.²¹ The courts usually have been quick to avoid this rule and have cir-

¹⁷ Ohio Rev. Code Ann. § 1781.02(B) (Page 1964).

¹⁸ Ohio Rev. Code Ann. § 1781.06 (Page 1964).

¹⁹ Ohio Rev. Code Ann. § 1781.02(A) (Page 1964).

²⁰ 6 Fletcher, Private Corporations § 2520 (rev. ed. 1950).

²¹ See Armstrong, "Can Corporations Be Partners?," 20 Bus. Law. 899 (1965); "May a Corporation Be a Partner?," 17 Bus. Law. 514 (1962); Note, "The Corporate Partner: An Exercise in Semantics," 35 N.Y.U.L. Rev. 548 (1960); Note, "Corporations—Status of a Corporation as a Partner in Missouri," 25 Kansas City Law Review 108 (1957); Note, 55 Mich. L. Rev. 588 (1957); Note, 35 Texas L. Rev. 265 (1956); Note, "The Corporation as a Partner," 1 Wash. U.L.Q. 76 (1955).

cumvented its effects by developing legal fictions such as a joint venture. Many authorities, however, are of the opinion that *even in the absence of specific charter provisions* corporations may validly become partners.

However, where a specific charter provision, authorizing it to act as a partner, exists, the authorities have uniformly held that a corporation may be a partner.²² The leading case in support of this conclusion is *News-Register Co. v. Rockingham Pub. Co.*²³ The Virginia Supreme Court of Appeals held that two newspaper publishing corporations, which amended their charters for the specific purpose of entering into an agreement to run a joint publishing business had formed a valid partnership. The court stated that the "general rule" that corporations unless expressly authorized have no power to enter into partnerships is old and well settled, but no more so than the converse proposition that when the authority is given the exercise of such power is entirely valid because the reason underlying the rule against its exercise no longer exists. The court said that there has never been any essential illegality in the power of a corporation to form a partnership and that the existence and valid exercise of such power depends solely upon the power being embodied in the charter of the corporate partner.²⁴ There is no specific prohibition in the Ohio Revised Code against a corporation acting as a partner and section 1701.03 provides that a corporation may be formed for any purpose for which natural persons may associate themselves.

Thus a corporation through charter authority or otherwise may act as a partner unless there is a prohibition under the Uniform Limited Partnership Act against a corporation becoming a partner. There is no such prohibition in the act. Although there is no separate definition of "person" specially contained in the Uniform Limited Partnership Act, a portion of the definition section of the Uniform Partnership Act, states that "person includes individuals, partnerships, corpora-

²² 6 Fletcher, Private Corporations § 2520 (1955). Implied authority was found in the charter in *Universal Pictures Corp. v. Roy Davidge Film Lab., Ltd.*, 7 Cal. App. 2d 366, 45 P.2d 1028 (1935). The court held that a corporation could enter into a partnership if it was authorized by its articles of incorporation, and absent specific authorization, if there was nothing to indicate that the corporation was not so authorized, the corporation could still enter into a partnership arrangement.

²³ 118 Va. 140, 86 S.E. 874 (1915).

²⁴ See also Annot., 60 A.L.R.2d 917, 920 (1958); 6 Fletcher, Private Corporations § 2520 (rev. ed. 1950); 1 Rowley, Partnership § 6.4(H)2 (2d ed. 1960). A suggested form of charter authorization is: "To enter into partnership or into any agreement for sharing of profits, including, but not limited to participation as a general or limited partner under the provisions of any Uniform Limited Partnership Act, or any statute or law permitting corporations to act as partners."

tions, and other associations." Further, section 1775.05(B) provides that chapter 1775 (Uniform Partnership Act) applies to "limited partnerships except so far as the statutes relating to such partnerships are inconsistent herewith." Therefore, since chapter 1781 (Uniform Limited Partnership Act) does not contain a definition of "person," the definition of "person" contained in the Uniform Partnership Act certainly would govern and include a corporation as a person. Additional support for this conclusion is found in section 1.02 of the Ohio Revised Code, which states that "as used in the Revised Code, unless the context otherwise requires. . . . (B) 'Person' includes a private corporation."

There is also case support for the proposition that a corporation may act as a partner under a partnership created under the Uniform Limited Partnership Act. The leading case decided under the Uniform Limited Partnership Act is *Port Arthur Trust Co. v. Muldrow*.²⁵ The Port Arthur Trust Co., a Texas corporation chartered to act as trustee under any lawful express trust committed to it by contract, will, or court appointment, was named trustee of three trusts established by J. W. Trousdale, Sr. Each trust was created for the benefit of a child of Mr. Trousdale and shortly after the execution of the three trust instruments, the trust company, as trustee for each of the three named income trusts, executed articles of limited partnership dated June 30, 1955, seeking to create a limited partnership between James W. Trousdale, Sr., as general partner, and the trust company as a limited partner in its separate capacity as trustee for each of the three income trusts. Each of the three trusts was to receive ten percent of the profits of the limited partnership. The Uniform Limited Partnership Act adopted by Texas in 1955²⁶ provided for filing of the certificate of limited partnership with the "Secretary of State." The secretary of state refused to file the instrument upon the grounds that it was necessary for a corporation to have express charter powers before it could enter into a limited partnership and that under the Texas Uniform Limited Partnership Act (which was identical to section 2 of the Uniform Limited Partnership Act and section 1781.02 of the Ohio Revised Code) a corporation is not a "person" as contemplated by that act. Mandamus was then brought in the Texas Supreme Court in an attempt to require the secretary of state to receive and file the limited partnership certificate. The Texas Supreme Court granted the writ of mandamus. In so deciding the court stated:

It is the contention of Respondent Muldrow that a corporation is not a "person" who may enter into a limited partnership, as is pro-

²⁵ 155 Tex. 612, 291 S.W.2d 312 (1956).

²⁶ 8 Uniform Laws Annotated 7 (Supp. 1966).

vided by Article 6132a, Section 2. This Section of the statute, among other things provides: ". . . a limited partnership is a partnership formed by two (2) or more persons. . . ." In discussing whether or not a corporation is a person . . . this Court said, ". . . it is generally held in this state, as well as elsewhere, that the word "person" in a statute, includes a corporation . . .," unless the context shows another meaning was intended. . . . Also Article 23, Sec. 2 prescribes that a "person" includes a corporation unless a different meaning is apparent from the context. . . .

The Uniform Limited Partnership Act used the word "person" or "persons," and there is no language in such Act excluding a corporation from the meaning of the word "person" as used in the Act, therefore, we hold that a corporation legally qualified under appropriate statutory provisions to act as a trustee may enter into a limited partnership organized to carry out a lawful purpose.²⁷

Subsequently, an Ohio court determined a similar question in *Cleveland Trust Co. v. Ingalls*.²⁸ In an action for declaratory judgment brought by the Cleveland Trust Co. as trustee of a testamentary trust of the Estate of Albert S. Ingalls, Jr., the trustee sought determination of two questions: does a corporate trustee have the capacity and power under Ohio law to join a limited partnership as a limited partner, and secondly, if it does so have the power, does the Cleveland Trust Co. have the power under the terms and provisions of the will to join the limited partnership as a limited partner? The decedent was the owner of a 6.67 percent interest in Taft, Ingalls & Co., a limited partnership which operated certain buildings in Cincinnati, Ohio under a partnership agreement entered into on August 1, 1959. The partnership agreement provided for four general partners who managed the business, and a considerable number of limited partners, including some trust estates and estates of deceased persons. In a well-reasoned opinion, the court reviewed the background of the "general rule" that a corporation may not ordinarily become a member of a partnership in the absence of statutory or charter authority and the court said in part: "As indicated in the statement of the rule, *supra*, the prohibition does not apply if there is authority by the charter or by statute for the corporation to enter into a partnership."²⁹

After reviewing *Port Arthur*,³⁰ the court stated:

It was contended that a corporation is not a "person" under the Uniform Limited Partnership Act. Ohio has adopted the act, and the Texas statute in question is the same as Section 1781.01,

²⁷ 155 Tex. 612, 616, 291 S.W.2d 312, 315 (1956).

²⁸ *Supra* note 5.

²⁹ 91 Ohio L. Abs. 70, 74, 23 Ohio Op. 2d 124, 126-27 (1963).

³⁰ *Supra* note 25.

Revised Code, which defines a limited partnership as "a partnership formed by two or more persons***." The Texas court disagreed with the contention, holding that the word "person" must be taken to include a corporation. In Ohio we have an even stronger argument for reaching the same result, for Section 1775.05(B), Revised Code, makes the Uniform Partnership Law applicable to limited partnerships except where inconsistent, and, as already seen, Section 1775.01(C), Revised Code, which is part of the Uniform Partnership Law, specifically includes corporations under the definition of persons.³¹

The court then held that not only did the Cleveland Trust Co., a corporation, have valid authority to participate in a limited partnership, but under the terms of the will it, as trustee, had the power to be a limited partner, notwithstanding the fact that it had no specific corporate charter authority.

One additional case, although not directly in point, lends further support to the proposition that the word "person" as used in the Uniform Limited Partnership Act must necessarily include corporations. In *Moss v. Standard Drug Co.*³² the court in construing the word "person" as used in a statute of limitations said:

The language of Section 11228 does not indicate that "person" is there used in a restricted sense.

The courts of Ohio have long recognized and followed the practice of construing "persons" as including corporations, where such construction is consistent with the apparent legislative intent. . . .³³

There is no language contained in the Uniform Limited Partnership Act or the Uniform Partnership Act indicating any intent of the legislature to restrict the meaning of "person." It seems apparent that the foregoing authorities squarely hold that a "person," as used within the Uniform Limited Partnership Act, includes corporations as well as natural persons.

C. *Name of the Limited Partnership*

Section 1781.02(A)(1) requires that the certificate shall state "the name of the partnership." Unlike the General Corporation Law, which provides that the name of the corporation shall end with or include certain designated descriptive terms indicating the corporate form,³⁴ the Limited Partnership Act is silent as to any formal name requirements to reflect limited partnership status. Although many limited partnerships have, in fact, been filed with the name "Limited"

³¹ *Supra* note 29 at 81, 23 Ohio Op. 2d 124, 130 (1963).

³² 159 Ohio St. 464, 112 N.E.2d 542 (1953).

³³ *Id.* at 469, 112 N.E.2d at 545.

³⁴ Ohio Rev. Code Ann. § 1701.04 (Page 1964).

or with the abbreviation "Ltd.," there apparently is no such requirement.³⁵ In contrast, a section of the Limited Partnership Associations Act provides that "Limited" shall be the last word of the name of every limited partnership association formed under the Limited Partnership Associations Act, and it is quite specific in stating that the omission of "Limited" in the use of the name of the association renders every person participating in the omission or knowingly acquiescing therein liable for any indebtedness or liabilities arising therefrom.³⁶

Ohio does have a Partnership Fictitious Names Act³⁷ which provides that "every partnership transacting business in the State under a fictitious name" must file with the clerk of the court of common pleas in the county in which its principal office or place of business is situated, a certificate stating the names in full of all members of the partnership, and their place of residence.³⁸ Although there are no cases directly in point, it is debatable whether the Fictitious Names Act would apply to a limited partnership under the Uniform Limited Partnership Act since the requirement of the Fictitious Names Act presumably is met by the certificate filed under the Uniform Limited Partnership Act, which requires the name and place of residence of each member and the designation of general and limited partners.³⁹

The only limitation as to the name of a limited partnership appears to be that contained in section 5 of the Uniform Limited Partnership Act,⁴⁰ which limits the use of the surname of a limited partner in the partnership unless it is also the surname of a general partner or, prior to the time when the limited partner became a limited partner, a business had been carried on under a name in which his surname appeared. A limited partner whose name appears in a partnership name contrary to the provisions of section 5 is liable "as a general partner to partnership creditors who extend credit to the partnership without actual knowledge that he is not a general partner."⁴¹ The use of the phrase "actual knowledge that he is not a general partner" indicates that the filing of the certificate of limited partnership, although constructive knowledge, is not "actual knowledge" for this purpose.

While almost any name chosen by the parties should be sufficient

³⁵ The survey conducted by the writers of this article, revealed that many limited partnerships formed under the Ohio act contain no designation in the name of the limited partnership that it is limited.

³⁶ Ohio Rev. Code Ann. § 1783.02 (Page 1964).

³⁷ Ohio Rev. Code Ann. §§ 1777.01-.06, 1777.99 (Page 1964).

³⁸ Ohio Rev. Code Ann. § 1777.02 (Page 1964).

³⁹ Ohio Rev. Code Ann. § 1781.02(A)(1)(d) (Page 1964).

⁴⁰ Ohio Rev. Code Ann. § 1781.05 (Page 1964).

⁴¹ Ohio Rev. Code Ann. § 1781.05(B) (Page 1964).

to comply with the Uniform Limited Partnership Act, it would seem prudent in some circumstances to include a designation of "Limited" or "Ltd." in the name of the limited partnership to reveal the limited nature of the organization.⁴²

D. *The Limited Partnership Agreement*

The Uniform Limited Partnership Act requires that a "certificate" be filed. There is no requirement that a limited partnership "agreement" be filed. Most limited partnerships do execute a separate "agreement" which is not filed. The relationship between partners is generally fixed by the terms of the partnership "agreement," if such agreement is not in conflict with statutory provisions or public policy.⁴³ The certificate, however, is generally directed toward the relationship of the partners to third parties. There is no requirement that the certificate should cover such things as sharing of any potential losses or allocation of certain tax credits; these are matters that should be covered in the "agreement."

E. *General Partners*

The general partner is subject to all of the liabilities and has all of the rights and powers of a partner in a partnership without limited partners. The only limitations upon the power of the general partner under the Uniform Limited Partnership Act are that a general partner may not do any act in contravention of the certificate; do any act which would make it impossible to carry on the ordinary business of the partnership; confess a judgment against the partnership; possess or assign rights in partnership property for other than a partnership purpose; admit a person as a general partner; admit a person as a limited partner unless the right to do so is given in the certificate; and continue the business with property of the partnership on the death, retirement or insanity of a general partner unless the right to do so is given in the certificate.⁴⁴ Thus, general partners have sole control of the business and are the only ones who can act on behalf of the limited partnership.

There is no requirement that the general partner make any contribution to capital and in many limited partnership arrangements the general partner does not make a capital contribution but agrees

⁴² The State of Florida in adopting the Limited Partnership Act provided that, in addition, the name must contain the name "Limited" or "Ltd." and also required a conspicuous sign exhibiting such name. Fla. Stat. Ann. § 620.05 (1956).

⁴³ Lanier v. Bowdoin, 282 N.Y. 32, 24 N.E.2d 732 (1939), *rehearing denied*, 282 N.Y. 611, 25 N.E.2d 311 (1940).

⁴⁴ Ohio Rev. Code Ann. § 1781.09 (Page 1964).

instead to perform services in the future for which he is granted a percentage of the profits of the partnership.

The partnership in operation conducts business comparable to other businesses, and thus has authority to do all things concomitant with its business objectives, such as the borrowing of money, issuance of checks, and opening of accounts. Since most limited partnerships are formed for specific ventures or for conduct of a specific business, the partnership agreement generally delineates the exact services and authority of the general partner.

Many partnership agreements provide that the general partner will not be liable to the partnership or any of the limited partners for any mistakes or errors in judgment, or for any act or omission by the general partner believed in good faith to be within the scope of authority conferred upon him by the partnership agreement.

The various powers which a general partner may exercise may be written in the partnership agreement as broadly as is consistent with the Uniform Limited Partnership Act, with the business purposes involved and with the practical realization of possible marketability limitations created if the scope of the general partner's authority is without limit. In particular it would certainly seem wise to provide for self-dealing provisions in the limited partnership agreement since it has been held that general partners may not take for themselves a business opportunity which rightfully should be taken for or shared with the partnership without knowledge or consent of the limited partner.⁴⁵ There is a provision in the act concerning the limited partner's right to deal with the partnership.⁴⁶

F. *Limited Partners*

The Uniform Limited Partnership Act is quite specific as to the rights, powers and liabilities of a limited partner. The limited partner's rights are essentially:

1. To have the partnership books kept at the partnership's principal place of business and "at all times to inspect and copy any of them";
2. Have on demand true and full information of all things affecting the partnership and a formal account of partnership affairs whenever circumstances render it just and reasonable; and
3. Have dissolution and winding up by decree of court.⁴⁷

⁴⁵ *Homestake Mining Co. v. Mid-continent Exploration Co.*, 282 F.2d 787 (10th Cir. 1960).

⁴⁶ Ohio Rev. Code Ann. § 1781.13 (Page 1964).

⁴⁷ Ohio Rev. Code Ann. § 1781.10 (Page 1964).

Of course, the limited partner also has the right to receive his share of profits or other compensation by way of income and to the return of his contribution under the restrictions of other provisions of the act. A limited partner's interest in the partnership is specifically declared to be personal property,⁴⁸ and his interest is assignable.⁴⁹

There are two types of assignments contemplated by the Uniform Limited Partnership Act. The assignment of a limited partner's interest constitutes the assignee either "a substituted limited partner" or "an assignee." The "substituted limited partner" acquires all of the rights of the assigning limited partner. These rights, essentially as outlined above, are the inspection of books, right to accounting, right to a dissolution by court decree, and sharing the profits. An "assignee" has no right to require any information or account of the partnership transactions or inspect the partnership books, and is only entitled to receive the share of the profits or other compensation by way of income or the return of his contribution to which his assignor would otherwise have been entitled.⁵⁰ An assignee may become a substituted limited partner if all of the members of the partnership, except the assignor, consent to the substitution, or if the assignor, being empowered by the certificate, gives the assignee the right of substitution. The assignee becomes a substituted limited partner when the certificate is appropriately amended.⁵¹ On the death of a limited partner, his executor or administrator has all the rights of the limited partner for the purpose of settling his estate, and in addition, has such power as the deceased limited partner had to constitute his assignee as a substituted limited partner.⁵²

There are actually two types of liability to which the limited partner is subject. The first is the liability to the partnership for the difference between his contribution as actually made and that stated in the certificate as having been made, and for any unpaid contribution which he agrees in the certificate to make in the future.⁵³ The act also provides that a limited partner holds as trustee for the partnership the specific property stated in the certificate as contributed by him but which was not contributed or wrongfully returned, and money or other property wrongfully paid or conveyed to him on account of his contribution.⁵⁴

⁴⁸ Ohio Rev. Code Ann. § 1781.18 (Page 1964).

⁴⁹ Ohio Rev. Code Ann. § 1781.19 (Page 1964).

⁵⁰ Ohio Rev. Code Ann. § 1781.19 (Page 1964).

⁵¹ Ohio Rev. Code Ann. § 1781.19 (Page 1964).

⁵² Ohio Rev. Code Ann. § 1781.21 (Page 1964).

⁵³ Ohio Rev. Code Ann. § 1781.17(A) (Page 1964).

⁵⁴ Ohio Rev. Code Ann. § 1781.17(B) (Page 1964).

The second type of liability of the limited partner concerns liability to third parties. While limited partners are not personally liable for partnership debts and obligations, there are circumstances in which the limited partner can subject himself to personal liability, presumably both tort and contract: (1) If the limited partnership uses the surname of the limited partner contrary to the act he is liable as a general partner to partnership creditors who extend credit without actual knowledge that he is not a general partner;⁵⁵ (2) the limited partner may become liable for false statements contained in the certificate of limited partnership;⁵⁶ (3) liability may arise if there has not been substantial compliance in "good faith" with the requirements of the certificate of limited partnership.⁵⁷ Of these three situations the improper use of the surname and the false statement in a certificate probably generate only contract liability and not tort liability in the usual case, since reliance by the third party is essential to liability. In the tort area the injured person normally would not have relied upon the partnership name, nor upon a false statement contained in the certificate. However, if there has not been substantial compliance in good faith with the certificate requirements, there is no express requirement of reliance and an injured party might be able to avail himself of unlimited liability against the limited partner. There are no reported cases found in Ohio which have considered tort liability against limited partners. For the most part, the cases which arise are actions brought by creditors against the partnership or the limited partner in which it is sought to obtain judgment in excess of the limited partner's contribution to capital, in satisfaction of judgment or payment of a debt.

The most important aspect of the liability of a limited partner could be that contained in section 1781.07 which states: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." The limited partner apparently must take "part in the control of the business," in addition to his exercise of his rights and powers as a limited partner. The important test which is obtained from the cases considering this section, seems to be whether a limited partner has the ultimate power and authority to make important business decisions for the partnership. The courts do not seem to restrict limited partners to their statutory powers, but instead approach each new fact situation on its merits, and certain

⁵⁵ Ohio Rev. Code Ann. § 1781.05(B) (Page 1964).

⁵⁶ Ohio Rev. Code Ann. § 1781.06 (Page 1964).

⁵⁷ Ohio Rev. Code Ann. § 1781.12(B) (Page 1964).

trends seem to have emerged from the decisions in point. It seems clear that section 7 precludes a limited partner from active domination and operation of the limited partnership, or from taking part in decisions which determine the business policy to any substantial degree. Conversely, it seems equally clear that the limited partner may consult with the general partner, advise general partners as to the conduct of business, do occasional errands for the partnership, and advise third persons as to the status of the partnership.⁵⁸ There are cases holding that a limited partner is liable as a general partner when the alleged limited partner was an authorized signer or co-signer of partnership checks,⁵⁹ and where his signature was required to withdraw partnership funds.⁶⁰

It is clear from a review of the cases cited that the activities of the limited partners should be restricted to their rights and powers as limited partners. Counselling and advice to the general partner are certainly not inconsistent with a lack of control, but any acts beyond that may cause suspicion.

Section 7 of the act seems to impose the burden of proof upon the plaintiff to demonstrate that the limited partner has taken part in the control of the business and thereby forfeited his limited liability. In this connection it appears that the control should be specifically pleaded in a petition filed in which an attempt is made to join a limited partner as a general partner; section 1781.26 of the Ohio Revised Code provides: "A limited partner, *unless he is also a general partner*, is not a proper party to proceedings by or against a partnership" (Emphasis added.)

There are no reported cases in Ohio construing this section of the act. The plaintiff must apparently demonstrate in his pleadings that he is joining the limited partner in a suit against a limited partnership by virtue of the loss of the limited partner's limited liability. On the other hand, the statute does not preclude an action directly against the limited partner, but simply precludes joinder of the limited partner with the partnership in an action by or against the partnership.

Section 11 of the Uniform Limited Partnership Act⁶¹ provides

⁵⁸ *Bergeson v. Life Ins. Corp. of America*, 170 F. Supp. 150 (D.C. Utah), *affirmed in part and reversed in part*, 265 F.2d 227 (10th Cir.), *cert. denied*, 360 U.S. 932 (1959); *Plasteel Products Corp. v. Helman*, 271 F.2d 354 (1st Cir. 1959); *Donroy Ltd. v. United States*, 196 F. Supp. 54 (N.D. Cal. 1961); *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954); *Vulcan Furniture Mfg. Corp. v. Vaughn*, 168 So. 2d 760 (Fla. App. 1964).

⁵⁹ *Russell v. Werner*, 96 Cal. App. 2d 986, 217 P.2d 43 (1950).

⁶⁰ *Holzman v. De Escamilla*, 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

⁶¹ Ohio Rev. Code Ann. § 1781.11 (Page 1964).

that a person who has contributed to the capital of a limited partnership business erroneously believing that he has become a limited partner, is not, by reason of his exercise of the rights of a limited partner, a general partner in the business or liable as a general partner, provided, that upon ascertaining the mistake, he promptly renounces his interest in the profits of the business or other compensation by way of income. The commissioner's notes to the Uniform Limited Partnership Act indicate that this section is to be one of the major innovations introduced by the act, and further indicates that only a violation of section 7 (taking part in control of the partnership by a limited partner) would prohibit taking advantage of the provisions of section 11.⁶² However, recent decisions have listed further exceptions to the saving provisions of section 11, including: false statements in the certificate with a loss suffered in reliance thereon, unlawful use of the limited partner's surname in the name of the partnership, and misrepresentation of a person as a general partner.⁶³

III. LIMITED PARTNERSHIP INTERESTS AS SECURITIES

Although not specifically included in the definition of a "security" under federal or state statutes, limited partnership interests are securities for purposes of registration under most statutes.

A. State Law

Section 1707.01(B) of the Ohio Revised Code defines "security" to include "any investment contract." Investment contract means a "contract transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."⁶⁴ The term would seem to encompass the usual limited partnership interest. In addition, sections 1707.01(D) and 1707.01(G) of the Ohio Revised Code provide an inference that limited partnership interests are "securities." Section 1707.01(G) provides that the term "issuer" means every person who has issued, proposes to issue, or issues any security, and the definition of "person" contained in 1707.01(D) includes a limited partnership. Thus, a limited partnership may be an issuer of securities. Section 1707.06(A)(3), dealing with transactions which may be registered by description, makes specific reference to the sale of securities representing an interest in a limited partnership.

⁶² 8 Uniform Laws Annotated 24 (1922).

⁶³ J. C. Wattenbarger & Sons v. Sanders, 191 Cal. App. 2d 857, 13 Cal. Rptr. 92 (1961).

⁶⁴ SEC v. W. J. Howey Company, 328 U.S. 293, 298-99 (1946).

Exemptions from registration are contained in section 1707.02 and 1707.03 of the Ohio Revised Code. The exemption most frequently relied upon in the formation of corporations, dealing with the initial sale of voting shares,⁶⁵ is not available to a limited partnership, inasmuch as this section is specifically limited to corporations, and, of course, the limited partnership interest has no vote.

Registration by description under section 1707.06(A)(3) requires less formality and involves less expense than registration by qualification under section 1707.09. Securities representing an interest in a limited partnership may be registered by description if the persons "interested in the sale or in any part of the subject matter thereof" do not and will not after the sale, exceed ten; if no commissions or other remuneration is paid in connection with the sale of such securities; if the total expense of sale does not exceed one percent of the total sales price of the securities; and if the sale is made in good faith.⁶⁶ When one or more of the partners, either general or limited, are not natural persons, a question arises as to the availability of registration by description. In counting heads to determine whether there are in excess of ten "persons," should a trust or corporation be counted as one person or should the beneficiaries of the trust and shareholders of the corporation be counted as "interested in the sale or any part of the subject matter thereof?"⁶⁷

If registration by description is not available for the sale of limited partnership interests, and neither the interests nor the transactions are exempt, there must be registration by qualification pursuant to section 1707.09, in which event the securities can only be sold by a licensed dealer. If a limited partnership is to sell its own interests, it must first obtain a dealer's license.⁶⁸

B. *Federal Law*

The definition of "security" contained in section 2(1) of the Securities Act of 1933 includes "investment contract" and "any interest commonly known as a 'security.'" Both of these terms would seem

⁶⁵ Ohio Rev. Code Ann. § 1707.03(O) (Page 1964).

⁶⁶ Ohio Rev. Code Ann. § 1707.06(A)(3) (Page 1964).

⁶⁷ Trusts created or trustees designated by law or judicial authority or by will are excepted from the definition of "person" in section 1707.01(D), and, therefore, as to such trusts, it seems apparent that the beneficiaries are counted in determining whether ten or more persons are interested in the sale or the subject matter. As to corporations and other entities, it is the current policy of the Ohio Division of Securities that the stockholders or the persons having ownership in such other entities are counted in determining the applicability of section 1707.06(A)(3).

⁶⁸ Ohio Rev. Code Ann. § 1707.14 (Page 1964).

broad enough to include a limited partnership interest. Further support for the proposition that limited partnership interests are "securities" under the Securities Act of 1933 is found in the inclusion of partnerships in the definition of "person" under section 2(2) and the requirements of (4) of schedule A that there be included "the names and addresses of all partners if the issuer be a partnership." The sale of limited partnership interests has been held to be amenable to the fraud provisions of the Securities Act.⁶⁹ Professor Loss, in his treatise on securities regulations, states that it is arguable in the usual situation where the assignee of a limited partnership interest is not, per se, a substituted limited partner, that the interest is not a security, at least where the offer has been made only to a small number of persons. In Professor Loss' vernacular, the problem is to distinguish between the public offering of securities parading as limited partnership interests and "an offering of a half interest in a hamburger stand."⁷⁰

The frequently relied upon intrastate and private offering exemptions from the registration requirements of section 5 of the Securities Act of 1933 are available for the sale of limited partnership interests. Also, the exemption of section 4(1) for transactions "by any person other than an issuer, underwriter, or dealer" would seem to be available prior to the formation of the limited partnership.

IV. FEDERAL INCOME TAX ASPECTS

Although a limited partnership is a partnership under state law, it does not necessarily follow that it will be taxed as a partnership for federal income tax purposes. Corporations validly formed under state statute have been taxed as partnerships;⁷¹ and partnerships validly formed under state statute have been taxed as corporations.⁷² A limited partnership, in a sense, possesses characteristics of both corporations and partnerships and theoretically could be taxed either as a partnership or a corporation. Until recently, tax practitioners had to guess as to tax treatment—corporation or partnership—of limited partnerships. This uncertainty curtailed the use of limited partnerships. In 1960 the Treasury adopted a set of regulations defining standards for determining whether or not an organization would be taxed as a corporation.⁷³ Since 1960, most limited partnerships, under

⁶⁹ *United States v. Wernes*, 157 F.2d 797 (7th Cir. 1946).

⁷⁰ Loss, *Securities Regulation* 505 (2d ed. 1961).

⁷¹ *Teitelbaum v. Comm'r*, 294 Fed. 2d 541 (7th Cir.) *cert. denied*, 368 U.S. 987 (1962).

⁷² *Foreman v. United States*, 232 F. Supp. 134 (S.D. Fla. 1964).

⁷³ *Treas. Reg. § 301.7701-1* (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

the regulations, will be taxed as partnerships and not as corporations.⁷⁴

A. *Tax Advantage of a Limited Partnership Over Corporation*

In some circumstances a limited partnership, taxed as a partnership, can command a clear tax advantage over a corporation. The following examples highlight areas of possible limited partnership preference.

1. Potential Operating Losses for the Business

If a new venture projects substantial operating losses, occasioned by start-up costs, initial depreciation, or unprofitable beginning operation, such losses can be "passed through" to and availed of directly by the partners in the limited partnership.⁷⁵ If corporate form is used such losses, absent subchapter S election, would be unavailable to offset other personal income of the shareholders.⁷⁶

2. Depreciation "Pass Through"

A business owning apartments, office buildings, or similar assets can obtain tax shelter through depreciation of such assets.⁷⁷ The depreciation, particularly in early years, can be economically fictitious in an inflationary economy: the tax law grants a paper deduction, while an inflationary economy yields an ever-increasing asset value. The organization can heavily increase the depreciation deduction in early years through bonus depreciation, accelerated depreciation, and selective determination of useful asset lives.⁷⁸ The investment credit, for qualifying personal property, in effect, can reduce the cost of such property by seven percent.⁷⁹ Such advantages as tax depreciation despite economic value inflation, accelerated depreciation, and investment credit can generate a taxable paper loss or tax free income offset in early years of business operation. A limited partnership, taxed as a partnership, passes through such tax advantages directly to its partners; and the partners enjoy cash flow with desired tax shelter. These benefits are available to the corporation, but *not* to its shareholders, in a non-subchapter S corporate operation.

⁷⁴ Treas. Reg. § 301.7701-1 (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁷⁵ Int. Rev. Code of 1954, §§ 701-702.

⁷⁶ Int. Rev. Code of 1954, §§ 11, 1371.

⁷⁷ Int. Rev. Code of 1954, § 167.

⁷⁸ Int. Rev. Code of 1954, §§ 167(b)(2)-(3), 179.

⁷⁹ Int. Rev. Code of 1954, § 38.

3. Avoidance of Double Tax

Income earned by a corporation often is subject to two taxes: a tax at the corporate level and a later tax at the shareholder level. The usual corporate tax rates of 22, 28, and 48 percent will apply depending upon the corporation income and other factors.⁸⁰ Shareholder dividends are taxed usually as ordinary income to the recipient shareholder.⁸¹ If the corporation initially pays a 48 percent rate on income and later pays the residue of the income as a dividend to a shareholder, in an assumed 50 percent personal tax bracket, the aggregate tax actually is 74 percent. Conversely, if the shareholder sells his stock at a profit, the profit usually is taxed at capital gains rates: assuming a 25 percent maximum rate against such profit,⁸² the effective tax (corporate rate plus capital gains rate to the shareholder) totals 61 percent. Many tax practitioners feel corporations, because of ultimate double taxation, are a tax disadvantage. In contrast income of a limited partnership is taxed directly to the partners. In selected circumstances, a limited partnership can achieve the best tax result because the double tax is avoided.

4. Limited Partnership as a Preference to a Subchapter S Corporation

A corporation can elect, under appropriate circumstances, to be taxed somewhat akin to a partnership under a subchapter S election.⁸³ If subchapter S is unavailable, the limited partnership may be best used at the outset. Specifically, the limited partnership may be preferable in the following cases to a subchapter S corporate election:

(a) If there are or could be more than ten owners involved: subchapter S can be used only if there are ten or less shareholders.⁸⁴

(b) If one of the investors is, or might be, a trust:⁸⁵ the trust device is a favorite in estate and income planning and the possibility often exists of a trustee acquiring stock title. Such trustee ownership thereafter precludes continuation of subchapter S election. The limited partnership may better suit such long range objectives.

(c) If a substantial portion of the income of the business is or may be attributable to rents, stock sales, or other similar so-called passive income: the subchapter S election cannot be used if more than

⁸⁰ Int. Rev. Code of 1954, §§ 11, 1551, 1562.

⁸¹ Int. Rev. Code of 1954, § 301.

⁸² Int. Rev. Code of 1954, §§ 1001, 1201.

⁸³ Int. Rev. Code of 1954, § 1371.

⁸⁴ Int. Rev. Code of 1954, § 1371(a)(1).

⁸⁵ Int. Rev. Code of 1954, § 1371(a)(2).

20 percent of any year's gross income consists of such passive income.⁸⁶

(d) If a loss, perhaps occasioned by depreciation, exceeds stockholder investment: losses may be lost if the basis of subchapter S shareholders (as to their stock and corporate indebtedness) is less than anticipated operating losses.⁸⁷ In a limited partnership, this problem can be avoided because partnership loans increase the basis of partnership accounts.⁸⁸ This step-up of basis permits operating losses, often attributable to depreciation, to pass through to the partners, while such losses might not have been available for pass through to shareholders in a subchapter S corporation because of basis limitation.

B. *Tax Classification of Limited Partnership—Partnership or Corporation*

The foregoing cases, in illustrating how a limited partnership may be an attractive vehicle from a tax standpoint, assumed the limited partnership would not be taxed as a corporation but rather as a partnership. While it is possible for a limited partnership to be taxed as either a partnership or a corporation,⁸⁹ the tax treatment of a limited partnership under the Treasury Regulations can be fairly predicted. The Treasury Regulations list the following attributes as major corporate characteristics: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests.⁹⁰ In comparing characteristics of an association (corporation) with those of a partnership under the regulations, the characteristics of (1) associates and (2) objective to carry on business and divide the gains therefrom, are to be ignored since they are considered common characteristics to both types of organization.⁹¹ In the Treasury's view, a business will be taxed as an association (corporation) if the business has more corporate characteristics than non-corporate characteristics. If a so-called "tie" exists as to the four remaining characteristics, the organization will be taxed as a partnership.⁹²

⁸⁶ Int. Rev. Code of 1954, § 1372(e)(5).

⁸⁷ Int. Rev. Code of 1954, § 1374(c)(2).

⁸⁸ Int. Rev. Code of 1954, §§ 705, 752; Treas. Reg. § 1.752-1(a) (1956).

⁸⁹ Treas. Reg. § 301.7701-3(b) (1960).

⁹⁰ Treas. Reg. § 301.7701-2(a)(1) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹¹ Treas. Reg. § 301.7701-2(a)(2) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹² Treas. Reg. § 301.7701-2(a)(3) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

In totaling the characteristics, the Treasury tests are merely mathematical; each factor presumably is given equal weight. While a court, in interpreting the regulations, might find the Treasury approach inflexible and arbitrary, the Treasury position offers promise of predictability in what otherwise had been a muddled field. Each of the four determinative characteristics should be analyzed in light of tax and business considerations of a limited partnership.

1. Continuity of Life

A corporation is assumed to have continuity of life. If a limited partnership fails to have "continuity of life," the characteristic is non-corporate. If the limited partnership is dissolved upon the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member, it does not have continuity of life. Recognizing this general requirement of dissolution under state statute, the regulations flatly say that a partnership subject to a statute corresponding to the Uniform Limited Partnership Act does not have continuity of life.⁹³ Under the regulations, non-continuity of life still exists although the partnership agreement permits a new partnership to be formed and continued by the remaining partners upon dissolution occasioned by withdrawal of a general partner, since such agreement to form a new partnership is considered to result primarily from a subsequent agreement among the remaining partners.⁹⁴

2. Centralization of Management

Centralization of management, as defined in the regulations, stems from a conferral of authority on a group of persons (constituting less than all members of the organization) to make management decisions.⁹⁵ A general partnership would not have centralization of management because of the mutual agency between members of the general partnership. Similarly, centralized management usually does not exist in a limited partnership subject to the Uniform Limited Partnership Act since the general partner or partners have interests of their own which they represent.

Recognizing that a limited partner has no voice in management, the regulations, however, state that centralized management usually would exist in a limited partnership if "substantially all the interests

⁹³ Treas. Reg. § 301.7701-2(b)(1) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹⁴ Treas. Reg. § 301.7701-2(b)(2) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹⁵ Treas. Reg. § 301.7701-2(c) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

in the partnership" are owned by the limited partners.⁹⁶ Questions raised are: (1) What is an interest? Is "interest" an interest in capital or an interest in profits or both? (Frequently the general partner has an interest solely in profits and the entire investment is made by the limited partners.) (2) What is substantially all? Tax law is replete with words as "major," "principal," "substantial," and "substantially all." Construction of such words has not been necessarily consistent. While in some cases it is difficult to predict whether a limited partnership would or would not have centralized management, if the general partner has a significant initial capital account in the partnership, it is believed the partnership should lack centralization of management.

3. Limited Liability

Limited liability is a corporate characteristic and exists if under local law no member is personally liable for the debts of the organization. Under the limited partnership statutes, the general partner has unlimited liability.⁹⁷ If the general partner is an individual, then unlimited liability apparently exists under the regulations regardless of the individual's financial position.⁹⁸ If the general partner has no substantial assets (other than his interest in the partnership) and if he is acting as an agent (dummy) of the limited partnership, then the general partner is not deemed personally liable. In such cases, however, the limited partners are deemed to have liability; therefore, the partnership, even in such case, would not have limited liability.

If a corporation acts as sole general partner and has substantial assets (other than its interest in the partnership), then, under the regulations, the corporation is deemed to have personal liability. This example raises an inference that personal liability may not exist where a corporation, not a dummy, has only capitalization required by state law and such capitalization does not constitute substantial assets (other than its interest in the partnership). The regulations, however, seem to say that personal liability exists in any event by concluding: "although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not really a 'dummy' acting as the

⁹⁶ Treas. Reg. § 301.7701-2(c)(4) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹⁷ Treas. Reg. § 301.7701-2(d)(2) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

⁹⁸ Treas. Reg. § 301.7701-2(d)(2) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

agent of the limited partners."⁹⁹ While the regulations are somewhat unclear, personal liability probably exists either against the general partner or the limited partners in virtually every limited partnership.

4. Free Transferability of Interests

Free transferability of interests is a corporate characteristic. Under the regulations, free transferability is deemed to exist if all members, or members owning substantially all interests, have power without consent of other members to substitute another, who is not a member of the organization, for themselves in the same organization. Such power of substitution must include all attributes of the transferor's interest.¹⁰⁰ If the limited partnership agreement permits limited partners to substitute new limited partners without consent, then such limited partners would have free transferability as to their interests and if they own substantially all the interests, the organization would have free transferability of interests.

However, it is fairly simple to avoid the corporate characterization of transferability of interests. The limited partner may be given an unlimited right to "assign" his interest, but also be given a right to "substitute" a new limited partner only with the consent of the general partner.¹⁰¹ Since virtually all property rights and benefits of a limited partnership interest pass by assignment,¹⁰² there appears to be only slight lessening of the marketability of a limited partnership interest in permitting assignment without substitution; yet the interests are not deemed freely transferable under the regulations.

5. Examples of Taxation

Since the regulations require only that two of the four characteristics be non-corporate for partnership taxation, in most cases limited partnerships will be taxed as partnerships. The rules can be applied to four typical cases to demonstrate this result.

Case 1. One or more of the general partners is an individual, investing a significant initial capital contribution and sharing in a substantial part of the profits; limited partners as a group invest a majority of the needed initial capital. The limited partnership should be taxed as a partnership because: (1) it lacks continuity of life (death or withdrawal of the individual terminates the partnership); (2) it

⁹⁹ Treas. Reg. § 301.7701-2(d)(2) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

¹⁰⁰ Treas. Reg. § 301.7701-2(e) (1960), as amended, T.D. 6797, 1965-1 Cum. Bull. 553.

¹⁰¹ Treas. Reg. § 301.7701-3(b)(2) (1960).

¹⁰² Ohio Rev. Code Ann. § 1781.19 (Page 1964).

lacks centralization of management (the general partner has a substantial interest); (3) it lacks limited liability (the general partner has unlimited liability); and (4) it lacks free transferability of interests (assuming the general partner has the right to consent to a new substituted limited partner but no restriction exists against assigning a limited partnership interest).¹⁰³

Case 2. Assume the same facts as case 1 except the general partner does not make a capital contribution and has an interest only in profits. The limited partnership will be taxed as a partnership since all corporate characteristics are absent except possibly centralized management.¹⁰⁴

Case 3. Assume the same facts as case 1 except the sole general partner is a corporation with substantial assets, other than its interest in the partnership. The limited partnership will be taxed as a partnership since none of the corporate characteristics obtain.¹⁰⁵

Case 4. Assume the same facts as case 1 except the sole general partner is a corporation with a significant interest in profits, without any capital interest and without substantial assets other than amounts required under state law for appropriate capitalization. The limited partnership again should be taxed as a partnership, although this result is questionable. The partnership does not have continuity of life or free transferability of interest. It may, however, have centralized management, depending on whether the interest of the corporate general partner in profits is deemed a substantial interest. The partnership probably does not have limited liability. However, two of the four corporate characteristics seem absent, and probably a third is absent, compelling, under the regulations, partnership tax treatment.¹⁰⁶

C. *Formation of Partnership Usually Is Tax Free*

A partnership is essentially a non-taxable entity. The partnership return is considered an information return and items of partnership income, deductions, and loss, while reported on the partnership return, are reportable by the partners as partnership income to such partners personally.¹⁰⁷ In most cases partners can contribute property to the partnership, as capital contribution, without recognition of gain or loss.¹⁰⁸ The rule applies equally to limited partners and general

¹⁰³ Treas. Reg. § 301.7701-3(b) (1960).

¹⁰⁴ Treas. Reg. § 301.7701-3(b) (1960).

¹⁰⁵ Treas. Reg. § 301.7701-3(b) (1960).

¹⁰⁶ Treas. Reg. § 301.7701-3(b) (1960).

¹⁰⁷ Int. Rev. Code of 1954, §§ 701-702.

¹⁰⁸ Int. Rev. Code of 1954, § 721.

partners. A limited partner is not permitted to render service in exchange for a capital account under most state statutes.¹⁰⁹ However, it is not uncommon for a general partner to receive a specified percentage of future profits under a partnership agreement in return for such partner's agreement to render future service. A general partner is not in immediate receipt of income merely because the partnership agreement grants the general partner a share of profits for future services to be rendered by the general partner.¹¹⁰ Such profits are taxable to the general partner as the profits are earned rather than upon formation of the partnership. However, if the general partner receives an immediate interest in partnership capital in return for future services, the regulations indicate such partner is immediately in receipt of income in the amount of the fair market value of the capital interest which the general partner receives upon partnership formation.¹¹¹ The problem usually is best resolved by simply granting to the general partner only an interest in profits and avoiding a grant of a capital interest to the general partner for prospective services.

D. *Treatment of Depreciation and Investment Credit*

If the partnership agreement is silent on the allocation of depreciation and investment credit, depreciation and investment credit are allocated on the basis of profit ratios.¹¹² The same rule obtains regarding property contributed to the partnership by partners as capital contribution.¹¹³ If the general partner contributes minimal or no capital, but receives a substantial share of net income for rendition of services, the allocation of depreciation and investment credit on profit ratios, in effect, shelters the general partner's share of net income to the detriment of the limited partners, who actually furnished substantially all of the capital which permitted the acquisition of partnership depreciable assets. It would seem possible, in that case, to allocate depreciation and investment credit under the partnership agreement to the limited partners on a basis different than profit-sharing ratios.¹¹⁴ If limited partners contribute all capital, the limited partners may be entitled to all depreciation and investment credit over the economic life of the property purchased with such capital. If the

¹⁰⁹ Ohio Rev. Code Ann. § 1781.04 (Page 1964).

¹¹⁰ Treas. Reg. § 1.721-1(b) (1956).

¹¹¹ Treas. Reg. § 1.721-1(b) (1956).

¹¹² Treas. Reg. § 1.702-1 (1956), as amended, T.D. 6777, 1965-1 Cum. Bull. 8; Treas. Reg. § 1.704-1(b) (1956), as amended, T.D. 6771, 1964-2 Cum. Bull. 177.

¹¹³ Int. Rev. Code of 1954, § 704(c)(1).

¹¹⁴ Treas. Reg. § 1.704-1(b)(2) (1956), as amended, T.D. 6771, 1964-2 Cum. Bull. 177.

allocation is consistent with economic reality and serves appropriate business purposes, without design for tax avoidance, the allocation should be recognized.¹¹⁵ The tax planner may have a myriad of available combinations in planning various allocations of depreciation and investment credit.

E. Basis Limitation and Operating Loss Problems

A partner may not deduct a partnership loss in a given year in excess of the partner's basis for his partnership interest at such time.¹¹⁶ This rule can create severe problems for limited partners of a partnership investing in highly-financed real estate ventures. For example, assume the general partner contributes service only and limited partners contribute 100,000 dollars of capital; the partnership borrows 900,000 dollars and constructs a 1,000,000 dollar real estate property. The aggregate tax depreciation for the first five years could total 300,000 dollars to 350,000 dollars with accelerated depreciation. Assume the general partners receive 30 percent of the profits and the limited partners receive 70 percent of the profits, and depreciation under the agreement is allocated on that basis. The depreciation allocated to the limited partners over the first five years could be from 200,000 dollars to 250,000 dollars (70 percent of the five-year depreciation). If the net income from the property before depreciation, and after interest expense, is substantially less than the depreciation (this often is the case) the limited partners' share of net loss for the five-year term may well exceed the 100,000 dollar investment of the limited partners. In this case, the limited partners could not deduct the entire loss during the five-year period. Any loss in excess of the limited partners' basis would be carried over and not currently deducted.¹¹⁷

In a general (non-limited) partnership, any borrowings of the partnership increase the basis of partners' interests allocated on the ratio of loss sharing since all partners are liable for such borrowings consistent with the loss ratio.¹¹⁸ Thus, the basis of each partner's interest in a general partnership is increased by his pro rata share of the partnership liability. A different rule prevails in limited partnerships since limited partners have limited liability and are not personally liable for partnership borrowings.¹¹⁹ Thus, in the above example,

¹¹⁵ S. Rep. No. 1622, 83d Cong., 2d Sess. 379 (1954).

¹¹⁶ Int. Rev. Code of 1954, §§ 704(d), 752.

¹¹⁷ Int. Rev. Code of 1954, §§ 704(d), 752.

¹¹⁸ Int. Rev. Code of 1954, §§ 704(d), 752.

¹¹⁹ Treas. Reg. § 1.752-1(e) (1956).

the general partner's basis would be increased by 900,000 dollars since the general partner is liable for that debt, but the limited partners would not enjoy any basis step-up as a result of the borrowing. The limited partners in the example actually were allocated the bulk of the depreciation deduction and consequently much of the loss would be currently non-deductible because of loss limitation. The problem can be avoided if the partnership debt can be handled so that only the property is subject to, and the partnership is not liable for, the debt. In this case the debt is allocated on a basis of profit-sharing ratios since no partner is liable for the debt.¹²⁰ In the example, assuming no partner were liable for the 900,000 dollar debt, the limited partners would receive an increase in basis of 630,000 dollars and their loss, occasioned by depreciation, will be available to them without partnership basis limitation.

F. *Sale or Transfer of Limited Partnership Interest*

The limited partner's partnership interest in most cases will be a capital asset.¹²¹ Accordingly, a sale of the limited partnership interest, whether by assignment or substitution, usually will create a capital gain or capital loss.¹²² Upon death of a limited partner, his interest in the limited partnership will receive a new income tax basis equal to fair market value at date of death. A sale, shortly after death, of such limited partnership interest should generate little, if any, capital gain or loss.¹²³ The interest of a limited partner should be capable of transfer under a Clifford Trust arrangement, thereby, in effect, giving the income for a period of ten or more years to a designated beneficiary while reserving the reversionary interest in the grantor.¹²⁴ If the limited partnership invests in depreciable real estate, the holder of the limited partnership interest may wish to enjoy the benefits of early-year depreciation and then transfer the limited partnership interest, after depreciation is considerably reduced, to a Clifford Trust so the higher net income yield will be taxed at lower rates.

CONCLUSION

A limited partnership is simply a statutory form of business organization. Because of double taxation of corporations and a desire of investors to avoid double tax, limited partnerships may enjoy an

¹²⁰ Treas. Reg. § 1.752-1(e) (1956).

¹²¹ Int. Rev. Code of 1954, § 741.

¹²² Int. Rev. Code of 1954, § 741.

¹²³ Int. Rev. Code of 1954, § 1014.

¹²⁴ Int. Rev. Code of 1954, § 671.

ever-increasing use. While a limited partner cannot take part in management or control of the partnership, if the limited partner has sufficient confidence in the general partner's business ability or if the business of the partnership is limited to a particular predictable venture, the inability of the limited partners to control partnership business operation may be no more a deterrent to investment than would be a minority stockholder position relative to a corporation.

A businessman with a proven or anticipated record of success, in need of further financing from equity sources, may find a limited partnership a highly attractive vehicle for the following reasons:

(1) Such businessman, as the general partner, assumes responsibility and authority for management control.

(2) Depending on business circumstances, the general partner perhaps makes little, if any, capital investment but takes an interest in profits for future services and does not realize income until profits are earned.

(3) In appropriate circumstances the general partner may limit liability through use of an adequately capitalized corporation.

(4) The general partner, depending upon the form of business, offers tax inducements to limited partners such as single tax contrasted to double corporate tax treatment, and allocation of depreciation and investment credit to limited partners on a basis in excess of profit allocations.

(5) The general partner, in effect, can be rewarded for services without suffering premature income tax consequence through capital gain appreciation if the partnership assets increase in value on a going-concern basis.

Investors, particularly high-income individuals, who have investable funds but little time to spend in operating a business, may find an investment in a limited partnership attractive:

(1) The limited partner avoids the double tax attributable to corporate earnings and dividends.

(2) A selective investment in limited partnerships owning or constructing depreciable property can generate depreciation tax shelter to the limited partner.

(3) The limited partner enjoys limited liability.

(4) The right of control to a minority investor in any venture often is not expected and not wanted, the real desire being profits through business abilities of other people.

(5) Limited partnership interests, while not as marketable and liquid as interests in publicly-traded companies, still can be assigned and sold in fashion similar to shares of corporations.

(6) A limited partner can handle his partnership interest for income tax and estate tax planning purposes by adoption of a gift program, establishment of a Clifford Trust, creation of a bargain or private annuity sale to family members, and by other selective tax planning techniques.

While a limited partnership is not a panacea for the many tax ills of our society and certainly is not a substitute for wide-spread corporate use, it can have a place in our business economy under appropriate circumstances. The improved tax certainty afforded by the Treasury Regulations, the inherent flexibility of the limited partnership, and the widespread adoption of the Uniform Partnership Act call for an increased awareness and understanding of this form of business organization.