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MORE BASIC PROBLEMS WITH LIMITED PARTNERSHIPS—GENERAL PARTNER CONTRIBUTIONS AND CAPITALIZATION[1]

EXECUTIVE SUMMARY

There are at least four potentially significant tax and legal issues concerning the amount of capital the general partner of a limited partnership must possess and the amount the general partner must contribute to the partnership on which there is no clear case law or other authority. In certain circumstances, any of these issues may constitute a substantial reason for avoiding the use of the limited partnership business organization form.

DISCUSSION

1) Introduction

In Issue No. 35 of this newsletter, dated September 18, 2006, I pointed out various similarities and differences between LLCs and limited partnerships under federal income tax law and New Hampshire business organization law, and I identified the very few situations in which a limited partnership may be preferable to an LLC for New Hampshire business people.

In addition to the legal and tax problems with the limited partnership form I mentioned in Newsletter Issue No. 35, readers should be aware of four additional problems that can arise specifically with respect to the general partners of limited partnerships. For some New Hampshire businesses, these problems, each of which I will briefly discuss below, may cause the limited partnership form to be even more unattractive.

2) The general partner "insufficient contribution and "insufficient interest" problems under federal income tax law

There is no clear federal tax authority on the issue of how much a general partner must contribute to a limited partnership and how much of an interest in the partnership the general partner must have in order to qualify as a general partner for federal income tax purposes. Thus, while it is likely that even a relatively small contribution and general partner interest will suffice for these purposes, we cannot be certain of this proposition,

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[1] I am indebted to Craig Standish, an associate with the law firm of McLane, Graf, Raulerson & Middleton, Professional Association, for the legal and tax research underlying this newsletter. I alone, however, am responsible for any error in the newsletter.

especially if the general partner in question makes only a small contribution to a limited partnership that has a very substantial capitalization. *See generally, Davison, Eleanor* (1953), 12 CCH TCM 293; *Rankowski, Frank* (1956), 14 CCH TCM 1441; see generally, Rands, *Passthrough Entities and Their Unprincipled Differences in Federal Tax Law*, 49 SMU Law Rev. 15 (1995).

However, if, in any such case, the Internal Revenue Service is successful in contending that the general partner's contribution or interest is insufficient, the federal income tax results for the partnership and for many of its partners may be serious. They may include, for example, a radical reallocation of partnership debt among the partners, which may result both in partner loss of basis and in partner recognition of phantom gain.

By contrast, under all U.S. LLC statutes, a person can serve as the manager of an LLC without making any contribution to it whatsoever. Thus, LLCs are entirely immune to the above general partner "insufficient contribution" and "insufficient interest" federal income tax issues.

3) The "insufficient contribution" issue under LLC business organization law

There is also no clear authority on how much the general partner of a limited partnership must contribute to the partnership in order to be viewed as a bona fide general partner for purposes of determining the legal validity of the partnership. In every case where a general partner makes only a small contribution to the partnership, this may open the door to a troubling claim against the partnership by a plaintiff that contends that an entity that purports to be a limited partnership is actually a general partnership, in which, accordingly, every partner has unlimited personal liability for entity debt. *See generally*, *Pearl v. Shore*, 95 Cal. Rptr, 157 (Cal. Ct. App. 1971); *Fisser v. International Bank*, 282 F.2d 231 (2d Cir 1960); *Arnold v. Browne*, 27 Cal. App. 3d 386 (Cal. Ct. App. 1972).

4) The "insufficient general partner capitalization" issue under LLC business organization law

Finally, there is no clear authority on how much capital the general partner of a limited partnership must have in order to meet the "adequate capitalization" requirement for overcoming veil-piercing claims. In the case of such a claim against a general partner who is an individual, the failure of the individual to have adequate capital may cause all of the assets of the individual and of the limited partners to be at risk in a claim against the purported limited partnership. In the case of such a claim against a general partner that is an entity, the assets both of the limited partners and of the individuals or entities that own the entity that is the general partner may be at risk. *See* cases cited in above paragraph.

It is true that in a veil-piercing case against an LLC, the LLC *itself* may have to show that its *own* capitalization is adequate for veil-piercing purposes. However, no *member* of the LLC need make such a showing. Thus, for LLCs, the adequacy of the personal assets of the manager is entirely irrelevant in a veil-piercing claim and cannot provide the basis for such a claim.