

When Does A Limited Partnership Possess the Corporate Characteristic of Limited Liability?

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I. INTRODUCTION

The Internal Revenue Code (IRC) places various organizations, including associations which are taxable as corporations, partnerships, and trusts, into specific categories for purposes of taxation and prescribes the standards applicable for determining whether an organization belongs in a particular category.¹ Four major characteristics must be considered when distinguishing between an association and a partnership: "centralization of management, continuity of life, free transferability of interests, and limited liability."² If an organization possesses more corporate than noncorporate traits, the Internal Revenue Service (IRS) will not treat the organization as an association.³ Continuity of life, centralized management, and free transferability of interests are readily identifiable corporate characteristics which have not caused the courts or the IRS great concern.⁴ On the other hand, limited liability is a characteristic which has created significant consternation.⁵

Ordinarily, if state law provides that a member of an organization is not personally liable for organizational debts, then the organization possesses the corporate trait of limited liability.⁶ A member is personally liable if "a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim."⁷

The liability of a general partner in a limited partnership depends on the amount of assets subject to creditor claims and the extent of the general partner's independence from control by the limited partners. Formation of an organization as a limited partner-

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¹I.R.C. § 7701; Treas. Reg. § 301.7701(b), T.D. 6503, 1960-2 C.B. 412.

²*Id.* § 301.7701-2(a)(2).

³*Id.* § 301.7701-2(a)(3).

⁴*See* *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Larson v. Commissioner*, 66 T.C. 159 (1976); *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942).

⁵*See* *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Larson v. Commissioner*, 66 T.C. 159 (1976); *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942).

⁶Treas. Reg. § 301.7701-2(d)(1), T.D. 6503, 1960-2 C.B. 412.

⁷*Id.*

ship⁸ contemplates that the general partner will have personal liability.⁹ A corporation possessing limited liability may be a general partner of a limited partnership.¹⁰ The corporation's personal liability as a general partner may depend on whether the corporation has substantial assets which partnership creditors can reach.¹¹ The corporation's contribution of services instead of cash or property to the limited partnership will not excuse the corporation from personal liability, provided the corporation has substantial assets.¹² Even if the corporate general partner does not have substantial assets subject to the creditors' claims, the corporation still may have personal liability when it "is not merely a 'dummy' acting as the agent of the limited partners."¹³ The synthesis of the above propositions provides the following rule: If an organization is created as a limited partnership, a general partner is not personally liable when it does not have substantial assets that can be reached by the creditors *and* when it "is merely a 'dummy' acting as the agent of the limited partners."¹⁴ In other words, an organization has the corporate characteristic of limited liability whenever the IRS finds that the organization is not personally liable because the general partner lacks substantial assets *and* acts as a dummy for the limited partner. Both the "substantial assets" and "dummy" determinations raise serious problems of interpretation which this Article resolves.

II. "DUMMY" CONCEPT

As previously stated, a general partner in a limited partnership that lacks substantial assets can still qualify as a bona fide general partner with personal liability, provided the general partner is not a "dummy" for the limited partners.¹⁵ Defining a dummy, however, is a highly controversial problem. In 1977, the United States Treasury Department unsuccessfully attempted to remove the concept from its regulations.¹⁶ The Treasury Department's failure means that the dummy concept will remain in the tax regulations for the foreseeable future, thereby requiring the adoption of a workable definition.

The dummy concept was derived from *Glensder Textile Co. v.*

⁸For a discussion of some of the considerations in forming a limited partnership, see J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* § 26, at 143-46 (1968).

⁹See UNIFORM LIMITED PARTNERSHIP ACT §§ 1, 9 (1916).

¹⁰J. CRANE & A. BROMBERG, *supra* note 8, § 26, at 146-47.

¹¹Treas. Reg. § 301.7701-2(d)(2), T.D. 6503, 1960-2 C.B. 412.

¹²*Id.*

¹³*Id.*

¹⁴*Id.*

¹⁵*Id.*

¹⁶42 Fed. Reg. 1039-44 (1977) (withdrawn at 42 Fed. Reg. 1489 (1977)).

Commissioner.¹⁷ In *Glensder*, which arose under an earlier version of the current tax regulations, the Board of Tax Appeals held that for purposes of taxation the organization in question resembled an ordinary partnership rather than a corporation.¹⁸ The board in *Glensder* made the following observation about the dummy concept:

Even within the form of limited partnership most generally known, in which general and limited partners are associated together, we may still suppose situations where the resemblance to corporate form would be so substantial as to justify classification of the limited partnerships as corporations. If, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors. But, as a practical matter, to suppose such a situation we must also suppose that the limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners.¹⁹

The language from *Glensder* suggests that a dummy is a partner without substantial assets who acts as an agent of the limited partners.²⁰ The regulations, however, adopted a conjunctive test for limited liability of a general partner: The general partner does not have personal liability when it lacks substantial assets and merely acts as a dummy agent for the limited partners.²¹ The IRS, therefore, intended the "dummy" concept to mean more than a partner lacking any substantial assets.

The most important development in this area of the law since the adoption of the current regulations is the Tax Court's decision in *Larson v. Commissioner*.²² In *Larson*, the Tax Court decided that the organization under scrutiny should be treated for tax purposes as a limited partnership.²³ More important, the Tax Court provided three standards for determining whether the general partner is a dummy. First, the court suggested that a general partner which is "totally

¹⁷46 B.T.A. 176 (1942).

¹⁸*Id.* at 187.

¹⁹*Id.* at 183.

²⁰See also 66 T.C. at 180-81.

²¹Treas. Reg. § 301.7701-2(d)(2), T.D. 6503, 1960-2 C.B. 412.

²²66 T.C. 159 (1976).

²³*Id.* at 185.

under the control" of the limited partners may be a dummy.²⁴ Second, the court suggested that a general partner may qualify as a dummy when the limited partners are empowered to direct the business actively through the general partner.²⁵ Third, the court stated that a general partner which is used as a screen to conceal the limited partner's "active involvement" in the conduct of the business may be a dummy.²⁶ Although the court did not indicate the need to distinguish among the various tests, this Article will establish the critical need to identify certain differences.

In 1979, the IRS acquiesced in the *Larson* decision.²⁷ Acquiescence in a decision means that the IRS accepts the conclusion reached by the court but "does not necessarily mean acceptance and approval of any or all of the reasons assigned by the [c]ourt for its conclusions."²⁸ The IRS acquiescence, therefore, indicates that the reasoning of the *Larson* court on the dummy issue is not necessarily accepted or approved by the Service. In fact, the Service warned that "caution should be exercised in extending the application of *Larson* to a similar case, unless the facts and circumstances are substantially the same."²⁹ Also, the IRS has indicated that consideration should be given to the effect that "new legislation, regulations, and rulings as well as subsequent court decisions" will have on *Larson*.³⁰ On the same day as the *Larson* acquiescence, the IRS issued Revenue Ruling 79-106,³¹ which derives from *Larson* and identifies certain factors that have a bearing on the four³² major corporate characteristics that determine the classification of an arrangement formed as a limited partnership. The IRS' acquiescence in *Larson* and the issuance of Revenue Ruling 79-106 are subtle efforts to provide a workable definition of "dummy."

Rather than acquiesce in *Larson*, the IRS could have acquiesced in *Zuckman v. United States*,³³ which also dealt at length with the dummy issue.³⁴ The court's holding in *Zuckman* equated the general

²⁴*Id.* at 181. Although some control may be vested in the limited partners, total control by the limited partners turns a general partner into a dummy. *Id.*

²⁵*Id.*

²⁶*Id.*

²⁷1979-1 C.B. 1.

²⁸*Id.*

²⁹*Id.*

³⁰*Id.*

³¹Rev. Rul. 79-106, 1979-1 C.B. 448.

³²Because associates and the object of carrying on business for joint profit are essential characteristics of all organizations engaged in business for profit, those two characteristics are generally ignored, thereby leaving only four basic ones. See Treas. Reg. § 301.7701-2(a)(2) (1965).

³³524 F.2d 729 (Ct. Cl. 1975).

³⁴*Id.* at 740-42.

partner's status as a dummy with the limited partner's "control" under section 7 of the Uniform Limited Partnership Act (U.L.P.A.).³⁵ The net effect of such a holding is to render the tax regulations on limited liability meaningless. If a court rules that a general partner is a dummy, then the limited partners have personal liability under section 7, according to *Zuckman*. Conversely, if a court rules that a general partner is not a dummy, then the general partner is personally liable. In either event, some member or members of the limited partnership will have personal liability; thus, the IRS under the reasoning of *Zuckman* could never establish the limited liability characteristic. Had the IRS acquiesced in *Zuckman*, then the tax regulations as they relate to dummy partners would be entirely useless. Some respected jurists believe that the court's holding in *Larson* on the dummy issue has the same effect as *Zuckman* in rendering the regulations meaningless.³⁶ Nevertheless, the tax regulations on limited liability do not have to be meaningless if the proper choice is made among the various tests in *Larson* for establishing dummy status.

Obviously, the interplay between a limited partner's section 7 liability and the limited partner's ability to transform a general partner into a dummy by the control exercised over the general partner must be reconciled. The failure to reconcile these two concepts would result in hopelessly circular regulations.³⁷

The task of reconciling these factors first requires a determination of the amount of control necessary to cause a limited partner to be deemed personally liable under section 7. Section 7 provides that "[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."³⁸ The failure to define what constitutes "taking part in the control of the business" is considered to be the greatest drawback to the limited partnership form of operation.³⁹ Although the statute and decisions dealing with section 7 do not decisively define "taking part in control of the business," a number of courts and scholars have reached

³⁵*Id.* at 741. Hereinafter, UNIFORM LIMITED PARTNERSHIP ACT § 7 (1916) will be referred to as § 7.

³⁶*See Larson v. Commissioner*, 66 T.C. at 188-90 (Dawson, C.J., concurring); *id.* at 205-06 (Quealy, J., dissenting).

³⁷Equating a general partner's status as a "dummy" with the control that the limited partners have in the partnership not only violates § 7 but also results in some members of the partnership always being personally liable; therefore, the IRS could never establish the corporate characteristic of limited liability under the *Zuckman* rule.

³⁸UNIFORM LIMITED PARTNERSHIP ACT § 7 (1916).

³⁹J. CRANE & A. BROMBERG, *supra* note 8, § 26 at 147-48.

a general consensus about the meaning of the section 7 phrase. A limited partner may be personally liable to the creditors of the partnership under section 7 when the limited partner assumes the day-to-day control of the partnership.⁴⁰ In *Delaney v. Fidelity Lease Ltd.*,⁴¹ the plaintiffs brought an action for breach of lease against a limited partnership, the sole corporate general partner, and the limited partners. The limited partners had dual capacities in that they were also officers of the sole corporate general partner. The limited partners in their officer roles conducted the day-to-day business of the partnership. Recognizing the difficulty of separating the acts of the limited partners into different categories, the Texas Supreme Court concluded that their day-to-day control as limited partners violated section 7.⁴²

A limited partner may also violate section 7 by exercising some fairly broad powers of control over the partnership. In *Holzman v. De Escamilla*,⁴³ the limited partners violated section 7 because they decided what crops to plant and controlled withdrawals from the partnership's checking account.⁴⁴ Although the limited partner's actions did not constitute "day-to-day" activities, they did constitute sufficient participation in the business to violate section 7. A limited partner's "active participation" in the business not only violates section 7 but also causes a limited partner to become personally liable as a general partner.

A number of courts require more than "active participation" by a limited partner to impose personal liability under section 7.⁴⁵ These cases require active participation *plus* a showing that the creditors detrimentally relied on the belief that the limited partner was actually a general partner.⁴⁶ The genesis for this approach to section 7 liability is premised on a basic assumption of the U.L.P.A.:

No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligations of the business; provided

⁴⁰Weil v. Diversified Properties, 319 F. Supp. 778 (D.D.C. 1970); Gast v. Petsinger, 228 Pa. Super. Ct. 394, 323 A.2d 381 (1974).

⁴¹526 S.W.2d 543 (Tex. 1975).

⁴²*Id.* at 545.

⁴³86 Cal. App. 2d 858, 195 P.2d 833 (1948).

⁴⁴*Id.* at 860, 195 P.2d at 834.

⁴⁵*See, e.g.*, Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244 (1977); Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757 (1950).

⁴⁶Frigidaire Sales Corp. v. Union Properties, Inc., 88 Wash. 2d 400, 562 P.2d 244; Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757.

creditors have no reason to believe at the times their credits were extended that such person was so bound.⁴⁷

In *Frigidaire Sales Corp. v. Union Properties, Inc.*,⁴⁸ a creditor of a limited partnership brought a claim against the corporate general partner and the limited partners individually for failure to pay an installment payment due on a contract. The Washington Supreme Court held that the limited partners were not personally liable, absent a finding that the creditor relied on the credit of the limited partners when extending credit to the partnership.⁴⁹ A majority of state statutes are silent on whether reliance is a necessary element of section 7 control.⁵⁰ The 1976 Revised U.L.P.A. implicitly states that reliance is intended to be a part of the section 7 determination.⁵¹ The 1976 version, however, has not been adopted in any state.

Judicial decisions interpreting the statute indicate that when a limited partner actively participates in the business it violates section 7 and becomes personally liable. Active participation can vary from making day-to-day decisions dealing with all organizational matters to periodic decisions relating only to major items. In addition to active participation, some courts have required that the creditor prove reliance as a necessary part of the section 7 test. Under either judicial standard, the limited partner must do more than possess the power to control⁵² the general partner to violate section 7. No commentator or court has suggested that mere possession of the power to control should result in imposing personal liability on the limited partner. If active participation satisfies the element of control for section 7, any quantum of control *less than* section 7 control by a limited partner should constitute sufficient authority to convert the general partner into a dummy. Logically, a limited partner that possesses the power to control but does not exercise such authority to actively participate in the business or to cause creditor reliance should *not* be held personally liable under section 7. Nevertheless, a limited partner's possession of the power to control should convert the general partner into a dummy, even

⁴⁷UNIFORM LIMITED PARTNERSHIP ACT § 1, Official Comment (1916).

⁴⁸88 Wash. 2d 400, 562 P.2d 244 (1977).

⁴⁹*Id.* at 406, 562 P.2d at 247.

⁵⁰Only Alabama and Delaware have expressly included reliance as an element of § 7 control. ALA. CODE tit. 10, § 10-9-41 (1975); DEL. CODE tit. 6, § 1707 (1974).

⁵¹See Revised UNIFORM LIMITED PARTNERSHIP ACT § 303(a) (1976).

⁵²This author uses "power to control" to mean that the limited partners arguably may possess certain rights by virtue of the partnership agreement to control the policies and decisions of the partnership. Such rights could be the power to remove the general partner, dissolve the partnership, approve or disapprove the sale of all or substantially all of the assets of the partnership, and amend the partnership agreement.

though the limited partner is not personally liable under section 7. The power to control or empowerment standard merely suggests that one consider the quantum of control that limited partners have over general partners by virtue of certain rights granted in the partnership agreement or certificate. The important rights include the powers to remove the general partner, dissolve the partnership, approve or disapprove the sale, lease, exchange, or mortgage, pledge all or substantially all of the partnership assets, and amend the partnership certificate.

Substantial support exists for defining "dummy" according to the power to control or empowerment standard. The Board of Tax Appeals in *Glensder* indicated that the general partners were dummies because the "limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners."⁵³ In *Larson*, the Tax Court indicated that a general partner could qualify as a dummy if the limited partners totally controlled the general partner⁵⁴ or if the partnership agreement empowered the limited partners to control the business actively through the general partner.⁵⁵ The *Larson* court also suggested a third test: A general partner is a dummy if the general partner is used as a screen to conceal the "active involvement" of the limited partners in the conduct of business.⁵⁶ Unfortunately, this third test causes confusion because it goes beyond "control" or the "power to control" to require "active involvement" or "participation," thereby violating the section 7 standard for imposing personal liability. Nevertheless, two of three definitions extracted from *Larson* support the "power to control" test. The IRS could easily argue in future cases that their acquiescence in *Larson* only involved the "power to control" definition rather than the "active participation" definition of dummy.

The limited partner's control over a dummy general partner has been likened to a shareholder's control in a corporation.⁵⁷ The analogy is not legally correct. The United States Treasury Regulations clearly indicate that a general partner which is a dummy for the limited partners is also an agent acting for its principal.⁵⁸ The directors of a corporation are fiduciaries and are not agents of the shareholders because the directors have no obligation to respond to the shareholders concerning the details of management.⁵⁹ Albeit the

⁵³46 B.T.A. at 183.

⁵⁴66 T.C. at 181.

⁵⁵*Id.*

⁵⁶*Id.*

⁵⁷46 B.T.A. at 183. See also *Larson v. Commissioner*, 66 T.C. at 197 (Simpson, J., dissenting).

⁵⁸Treas. Reg. § 301.7701-2(d)(2) (1965).

⁵⁹RESTATEMENT (SECOND) OF AGENCY § 14, Example c (1958).

analogy is not legally correct, the analogy is at least useful to exemplify those powers which give the limited partners control over a general partner, thereby converting the general partner into a dummy. The traditional powers that the shareholders possess over the directors of a corporation are the powers to remove directors,⁶⁰ dissolve the corporation,⁶¹ approve or disapprove the sale of all or substantially all of the assets of the corporation,⁶² and amend the articles of incorporation.⁶³ A limited partner's possession of such powers is not sufficient to cause a limited partner to be personally liable under section 7.⁶⁴ In fact, the 1976 Revised U.L.P.A. proposes that limited partners can be vested with such powers without causing personal liability.⁶⁵ Ergo, the limited partner's possession of such powers should be sufficient to convert the limited partnership's general partner into a dummy for purposes of the tax regulations but should not cause personal liability for the limited partner pursuant to section 7.

The question can be asked fairly whether the limited partners can have *any* power of control over the general partner without converting him into a dummy. The Treasury Regulations provide that in the case of a limited partnership subject to a statute corresponding to the U.L.P.A.,⁶⁶ each general partner may be personally liable.⁶⁷ In other words, if limited partners only possess those powers of control which are sanctioned by the Act, then the general partner will not be deemed a dummy. The limited partner's power of control over a general partner is defined in sections 9 and 10 of the Act.⁶⁸ The most

⁶⁰ABA-ALI MODEL BUS. CORP. ACT § 39 (1969).

⁶¹*Id.* § 83.

⁶²*Id.* § 79.

⁶³*Id.* § 59.

⁶⁴An analysis of the § 7 cases indicates that *at least* "active involvement" by a limited partner is required for imposing personal liability. Therefore, simply possessing certain powers would not cause personal liability.

⁶⁵UNIFORM LIMITED PARTNERSHIP ACT § 303 (1976 version).

⁶⁶The Treasury Regulations do not refer to the 1976 amendments made to the U.L.P.A. because the regulations were adopted prior to any amendments to the Act.

⁶⁷Treas. Reg. § 301.7701-2(d)(1) (1965). The argument can be made that subparagraph (d)(1), which contains the U.L.P.A. reference, refers to subparagraph (d)(2), which contains the "dummy" language, and that a "dummy" therefore could exist even under a U.L.P.A. partnership. *Glensder* also arguably supports this argument because the court stated that "even within the form of limited partnership most generally known, in which general and limited partners are associated together, we may still suppose situations in which the resemblance to corporate form would be so substantial as to justify classification of the limited partnerships as corporations." 46 B.T.A. at 183.

⁶⁸The UNIFORM LIMITED PARTNERSHIP ACT §§ 9-10 (1916) provide:

§ 9. Rights, powers and liabilities of a general partner

(1) A general partner shall have all the rights and powers and be sub-

significant powers granted to the limited partners are the powers to dissolve and to approve or disapprove the admission of a new general partner.⁶⁹ Any powers granted in the certificate or partnership agreement to the limited partners to control the general partner beyond those sanctioned by sections 9 and 10 of the Act seriously increase the possibility that the IRS will categorize the general partner as a dummy. Essentially, one would be in "uncharted waters." The only indication that some nonsanctioned powers may be included in the partnership agreement is the language from *Larson* which permitted the limited partner to have the power of removal over the general partner without converting the general partner into a dummy.⁷⁰ Yet, the IRS' recent pronouncement in Revenue Ruling 79-106 indicated that the limited partner's right or *lack* of right to vote on the removal and election of general partners will have significance in determining the limited liability characteristic. Thus, reliance on *Larson* for this point may be risky. The IRS also considers that the limited partner's right or *lack* of right to vote on the sale of all or substantially all of the assets of the partnership will be important in determining limited liability. Conse-

ject to all the restrictions and liabilities of a partner in a partnership without limited partners, except that without the written consent or ratification of the specific act by all the limited partners, a general partner or all of the general partners have no authority to

- (a) Do any act in contravention of the certificate,
- (b) Do any act which would make it impossible to carry on the ordinary business of the partnership
- (c) Confess a judgment against the partnership,
- (d) Possess partnership property, or assign their rights in specific partnership property, for other than a partnership purpose,
- (e) Admit a person as a general partner,
- (f) Admit a person as a limited partner, unless the right to do so is given in the certificate,
- (g) Continue the business with partnership property on the death, retirement or insanity of a general partner, unless the right to do so is given in the certificate.

§ 10. Rights of a limited partner

- (1) A limited partner shall have the same rights as a general partner to
 - (a) Have the partnership books kept at the principal place of business of the partnership, and at all times to inspect and copy any of them,
 - (b) 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
 - (c) Have dissolution and winding up by decree of court.
- (2) A limited partner shall have the right to receive a share of the profits or other compensation by way of income, and to the return of his contribution as provided in sections 15 and 16.

⁶⁹*Id.* §§ 9(e), 10(c).

⁷⁰66 T.C. at 181.

quently, the best advice is to stay within the "safe harbor" of the U.L.P.A.'s sanctioned powers.

Reliance on the power-to-control test will have serious consequences for states that adopt the Revised U.L.P.A. or various state blue sky regulations dealing with real estate programs. The impact on the Revised U.L.P.A. is clear. The greater powers granted to limited partners⁷¹ are specifically the types of powers that will convert the general partner into a dummy under the tax regulations. Possession of these powers under the 1976 Act will automatically clothe the organization with the corporate characteristic of limited liability if the general partner is also without substantial assets.⁷² In sum, the dummy issue would disappear if a partnership incorporated the greater powers provided in the Act. Obviously, the problem of defining a "dummy" is a deterrent to the adoption of the Revised Act.

⁷¹The 1976 Revised UNIFORM LIMITED PARTNERSHIP ACT provides:

§ 303. Liability to Third Parties

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. However, if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

- (1) being a contractor for or an agent or employee of, the limited partnership or of a general partner;
- (2) consulting with and advising a general partner with respect to the business of the limited partnership;
- (3) acting as surety for the limited partnership;
- (4) approving or disapproving an amendment to the partnership agreement; or
- (5) voting on one or more of the following matters:
 - (i) the dissolution and winding up of the limited partnership;
 - (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business;
 - (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
 - (iv) a change in the nature of the business; or
 - (v) the removal of a general partner.

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him in the business of the limited partnership.

⁷²The second part of the writing suggests that the substantial assets requirement can be reasonably identified and complied with to avoid the difficult issue of determining "dummy status."

Use of the power-to-control standard will also affect limited partnerships in states which have adopted certain blue sky regulations. The Midwest Securities Commissioners Association⁷³ statement of policy regarding real estate programs mandates that

[t]o the extent the *law of the state in question is not inconsistent*, the limited partnership agreement *must* provide that a majority of the then outstanding limited partnership interests may, without the necessity for concurrence by the general partner, vote to (1) amend the limited partnership agreement, (2) dissolve the program, (3) remove the general partner and elect a new general partner, and (4) approve or disapprove the sale of all or substantially all of the assets of the program.⁷⁴

Obviously, if a state adopts the Revised U.L.P.A., these four rights are mandatory. The Central Securities Administration Council⁷⁵ identifies four similar rights⁷⁶ and states that these rights should be included in the partnership agreement, provided the limited partners are not exposed to personal liability as a result of such a grant.⁷⁷ Clearly, both governing groups focus primarily on only state law as determining whether such broad powers should be given to the limited partners. This approach is not well conceived. The commissioners' definitions automatically convert the partnerships into "dummies" by requiring those greater powers without reference to the tax impact. The only tax consideration provided in the regulations of the Midwest Securities Commissioners Association is that the limited partnership either have a favorable tax ruling from the IRS or an opinion of counsel that the partnership will be taxed as a partnership and not as an association.⁷⁸ Certainly, the performance of this task is made more difficult by the failure of the blue sky laws to consider the tax effect of mandating the inclusion of such powers or rights in the partnership agreement.

⁷³A recent listing of member states included: Alabama, Arizona, Arkansas, California, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Nebraska, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, and Wyoming. [1976] 1 BLUE SKY L. REP. (CCH) ¶ 4721, at 551. Since the list was compiled, Alaska and Florida have become members. This information is based on contacts with the securities offices of those states.

⁷⁴[1976] 1 BLUE SKY L. REP. (CCH) ¶ 4821, at 645-3 (emphasis added).

⁷⁵Member states are Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, and Wisconsin. *Id.* ¶ 4877, at 687.

⁷⁶*Id.* ¶ 4877, at 693.

⁷⁷*Id.*, at 694.

⁷⁸*Id.* ¶ 4821, at 657.

III. SUBSTANTIAL ASSETS CONCEPT

Because the limited liability test is conjunctive,⁷⁹ a showing that the general partner has substantial assets preserves the personal liability attribute of the limited partnership.⁸⁰ Clearly, the general partner's equity position in the limited partnership should not be considered in the substantial assets determination.⁸¹ Further, the quantum of assets owned by the general partner may still be considered to be substantial even though the "assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization."⁸²

The IRS has guidelines to measure the substantiality of a general partner's assets or net worth.⁸³ Revenue Procedure 72-13 provides the following methods of calculation:

.02 If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than \$2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or \$250,000, whichever is the lesser; if the total contributions to that partnership are \$2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions. In computing the net worth of the corporate general partner, for these purposes, its interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership will be excluded.

....

.04 For purposes of computing the net worth of the corporate general partner in .02 and .03 above, the current fair market value of the corporate assets must be used.⁸⁴

The United States Treasury, however, does not have any guidelines to measure the substantiality of assets when the general partner is an individual or entity other than a sole corporation.⁸⁵ The simple answer to this problem would be to apply by analogy the sole

⁷⁹See Treas. Reg. § 301.7701-2(d)(2) (1965).

⁸⁰*Id.* A showing that a general partner has substantial assets forecloses any inquiry into the more troublesome "dummy" issue.

⁸¹See *id.*

⁸²*Id.*

⁸³Rev. Proc. 72-13 § 2.02, .04, 1972-1 C.B. 735.

⁸⁴*Id.*

⁸⁵For purposes of clarity, the author will use the word "individual" to include individuals and entities other than a sole corporation when discussing the "substantial assets" test.

corporate general partner net worth requirements to all general partners. Such high net worth requirements for individuals, however, unnecessarily focuses on capital. The regulations provide that "an organization has the corporate characteristic of limited liability *if under local law* there is no member who is personally liable for the debts of or claims against the organization."⁸⁶ When the organization is a limited partnership, one of the determinations which must be made under *local law* is whether the general partner has substantial assets.⁸⁷ In the case of a sole general corporate partner, the Treasury Regulations should prevail over conflicting local law on the standard to be used when measuring the substantiality of a general partner's assets.⁸⁸ Because the Treasury Regulations are silent on establishing a specific standard for individuals, local law should be examined to determine whether any minimum standards are effective.⁸⁹ The statement of policy adopted by the Midwest Securities Commissioners Association on real estate programs generally requires that the "financial condition of the general partner or general partners . . . be commensurate with any financial obligations assumed in the offering and in the operation of the program."⁹⁰ More specifically, the association's regulation provides:

As a minimum, the general partners shall have an aggregate financial net worth, exclusive of home, automobile and home furnishings, of the greater of either \$50,000 or an amount at least equal to 5% of the gross amount of all offerings sold within the prior 12 months plus 5% of the gross amount of the current offering, to an aggregate maximum net worth of the general partners of one million dollars. In determining net worth for this purpose, evaluation will be made of contingent liabilities to determine the appropriateness of their inclusion in the computation of net worth.⁹¹

This regulation provides a standard for measuring the substantiality of an individual general partner's assets.

The substantiality of assets is undeniably determined by reference to the total contributions made to the limited partnership. The question remains about what specific items should be included in the total contributions tally. Actual cash payments made by the limited partners rather than total committed capital should be in-

⁸⁶Treas. Reg. § 301.7701-2(d)(1) (1965) (emphasis added).

⁸⁷*Id.* § 301.7701-2(d)(2).

⁸⁸*See id.* § 301-7701-1(c).

⁸⁹*Id.* § 301.7701-2(d)(1).

⁹⁰[1976] 1 BLUE SKY L. REP. (CCH) ¶ 4821, at 635.

⁹¹*Id.*

cluded, at least when the balance of the capital commitment is evidenced only by a subscription agreement.⁹² If the balance of the commitment is evidenced by a negotiable promissory note, the amount of the capital contribution should include the fair market value of such notes.⁹³ In addition, if other noncash property is contributed, the contributions should include the current market value of such assets.⁹⁴

Certain loan transactions also raise problems when determining the total contributions made to the limited partnership. It was determined in a recent revenue ruling that a nonrecourse loan⁹⁵ "from the general partner [corporate or otherwise] to a limited partner or to the partnership is a contribution to the capital of the partnership by the general partner rather than a loan."⁹⁶ Such loans naturally increase the total contributions to the limited partnership and thereby require a higher net worth for the general partner to qualify under the substantial asset test.

Nonrecourse third party loans have a vastly different impact. Originally, nonrecourse third party loans to the limited partnership, which gave the creditor the option of obtaining an equity interest in the partnership were treated as capital "placed at the risk of the venture."⁹⁷

Currently, the IRS will not provide an advance ruling that an organization qualifies as a limited partnership for tax purposes if a "creditor who makes a nonrecourse loan to the limited partnership [has or can] acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital or property of the limited partnership other than as a secured creditor."⁹⁸ Therefore, an arm's length nonrecourse loan made by a lender, who is neither a partner nor an affiliate of a partner and who does not obtain an equity interest or a right to such an interest in the partnership, should have no effect on the total contributions to the limited partnership. Thus, the nonrecourse loan will not increase the general partner's net worth.

The treatment of nonrecourse loans is important not only for determining what total contributions have been made to the partnership but also for comparing the general partner's net worth to

⁹²TAX MNGM'T PORTFOLIO (BNA), No. 161-2, at A-31 (1975).

⁹³*Id.*

⁹⁴*See id.*

⁹⁵A nonrecourse loan is a type of security loan which bars the lender from action against the borrower if the security value falls below the amount required to repay the loan.

⁹⁶Rev. Rul. 72-135, 1972-1 C.B. 200.

⁹⁷Rev. Rul. 72-350, 1972-2 C.B. 395.

⁹⁸Rev. Proc. 74-17, 1874-1 C.B. 439.

the potential liabilities of the limited partnership. Naturally, the substantial asset determination should focus on a comparison between the quantum of assets the general partner has to satisfy creditor claims, exclusive of his partnership investment, and the quantum of creditor claims that could arise to charge his assets.

The IRS unofficially has maintained that the general partner's net worth should be measured against total liabilities of the partnership, including nonrecourse loans.⁹⁹ In fact, the IRS would argue that an individual general partner whose current and future earning capacity is insufficient to cover the monthly payments on nonrecourse loans does not have substantial assets.¹⁰⁰ The IRS apparently treats proof that a substantial portion of the outstanding obligations are nonrecourse as further evidence that the organization has limited liability.¹⁰¹ The IRS position, however, does not have any explicit support in the IRC or the Treasury Regulations.¹⁰² Nonrecourse loans by definition do not permit recourse against the general partner personally and therefore should be ignored when determining the substantiality of the assets that the general partner has at risk, exclusive of his partnership interest, to satisfy a creditor's claims.

IV. SUMMARY

To prove that a limited partnership possesses the corporate trait of limited liability, the IRS must show that the general partner does not possess substantial assets *and* is a dummy for the limited partners. The only federal guidelines on the substantial assets test are those dealing with the limited situation in which the sole general partner is a corporation. For all other general partner situations, the substantial assets determination is undefined. The state blue sky regulations, however, should fill this gap for federal tax purposes.

The problem of defining "dummy," however, is not as easily resolved. If a "dummy" is defined as a general partner that is controlled by the limited partners to the extent that the limited part-

⁹⁹*Shop Talk*, 41 J. TAX 382, 382 (1974).

¹⁰⁰*Id.*

¹⁰¹*Id.*

¹⁰²Treas. Reg. § 301.7701-2(d)(2) (1965) arguably supports the IRS position. The regulation provides in pertinent part:

Furthermore, if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of *the obligations of the organization*.

Id. (emphasis added).

ners have personal liability under section 7 of the U.L.P.A., then the regulation is circular and meaningless. Unfortunately, a number of judicial decisions support that definition.

A more rational interpretation can be offered for the "dummy" term. Most jurisdictions agree that section 7 requires as a minimum that the limited partners take some active participation in the partnership to expose them to personal liability. *Larson* provided three possible definitions for the "dummy" term. Two of the three definitions indicate that a dummy should be a general partner that the limited partners have the power to control. The power to control a general partner and active participation under section 7 are clearly different standards for measuring the limited partners' involvement in the partnership. If the limited partner has the power to control, then the general partner is a dummy. Logically, if the limited partners only possess the power to control and do not actively participate in the partnership, the limited partners are not personally liable under section 7 of the U.L.P.A.

Limited partners possess the power to control the general partner when the partnership agreement or certificate provides that the limited partners have the power to remove the general partner, to approve or disapprove the sale of all or substantially all of the assets of the partnership, and to amend the partnership agreement or certificate. Some control, however, is permitted without causing the general partner to be a dummy. The powers to cause dissolution and to approve or disapprove the admission of a new general partner are permissible. Any powers granted in the partnership agreement or certificate beyond the two approved powers may cause the general partner to be deemed a dummy because the limited partners possess the power to control.

The 1976 Revised U.L.P.A. requires that the limited partners possess the power to control the general partner. The blue sky regulations also require that the limited partners possess the power to control, provided such powers are permitted as a matter of state law. These guidelines unfortunately fail to consider their impact on the dummy concept under the tax regulations. The best advice is to remain within the safe harbor of the sanctioned powers of the current U.L.P.A. when determining the amount of control that limited partners should possess over general partners.

