Practical Guide to Forming a Partnership in Utah

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CHECKLIST OF QUESTIONS TO CONSIDER WHEN FORMING A PARTNERSHIP

I. FORMING THE PARTNERSHIP

[ ] 1. What will be the legal name of the partnership?
[ ] 2. Who are the partners?
[ ] 3. What rights and duties will each partner have?

II. MANAGEMENT

[ ] 4. What management structure will the partnership use?
[ ] 5. What is the purpose of the partnership?
[ ] 6. How will the partnership deal with deadlocks and disputes?
[ ] 7. How will the partnership arrange banking?
[ ] 8. Will the partnership have an annual meeting?
[ ] 9. What rights will limited partners retain?

III. BASIC TAX PLANNING AND FINANCIAL ACCOUNTING

[ ] 10. What taxable year will the partnership use?
[ ] 11. Which accounting method will the partnership use?

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12. What inventory costing method will the partnership use?

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24. Will there be a tax matters partner?

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Introduction

When a client seeks help in forming a partnership in Utah, the attorney must inquire about several key questions. This guide offers a checklist to facilitate that process and to aid the client and the attorney in considering the main options available. The outline of this article and its accompanying checklist might serve as the basis for an attorney-client interview, to generate information from the client, or as an outline for drafting parts of a partnership agreement. Typical partnership agreements cover
basic terms of formation, purposes, powers, rights, duties, contributions, allocations, distributions, transferability of interests, terminations, and miscellaneous provisions.

The accompanying annotations identify the general legal issues implicit in these basic subjects and checklist questions. The annotations present pertinent statutes and points of law, as well as useful secondary sources. In addition, alternatives open to both general and limited partnerships are presented, as well as pitfalls to be avoided. Finally, the annotations offer suggestions as to how the client's answers to the questions can be reflected in the documents that the attorney prepares in completing the partnership formation process.

This article is a companion to the previously published "Practical Guide to Forming a Closely-Held Corporation in Utah," which appeared in this journal at 9 B.Y.U. J. PUB. L. 189 (1995). The two articles, however, differ somewhat in nature. By comparison, gathering information is more straightforward in forming a corporation than in putting together a partnership, mainly because the partnership form offers greater flexibility than does the corporate structure. Given such flexibility, the lawyer and client must think creatively and openly when designing a partnership. Hopefully, the following discussions, generated in the law school classroom setting, will be useful in commencing that process under Utah law.

I. Forming the Partnership

A. Requirements for a general partnership name

In the state of Utah no statutes specifically address how to obtain and keep a general partnership name. Although there is a separate section concerning limited partnerships, no such section exists for the general partnership. Instead, a general partnership seems to be included in section 42-2 of the Utah Code, "Conducting Business Under Assumed Name." 1

1. Certificate of doing business

The Utah Code requires that any person doing business in the state under an assumed name, such as a partnership, first file a certificate with the Division of Corporations and Commercial Code ("Division") of the Utah Department of Commerce that states the following:

- The name in which that entity will conduct business.

1. The heading for section 42-2-5 of the Utah Code is Certificate of assumed and of true name - Contents - Execution - Filing. Yet nowhere in the body of section 42-2-5 does it refer to the filing of a true name. We can only assume that partnerships should file to avoid any possible harm that not filing might create.
• The full true names of the persons owning the entity and those who will carry on the business.
• The principal location of the entity.
• The addresses of those carrying on the business.  

2. Execution of the Certificate

The code further requires that the person who owns, and the person who will be carrying on, conducting, or transacting the business shall execute a certificate and file it with the Division. The Division must approve its form and either stamp or seal it and indicate the time of day and date of approval within 30 days after the business has started.

3. The partnership name

The name itself needs to be distinguishable from other business names and trademarks on record with the Division in order for the name to be accepted. However,

[readers of this list may draw conclusions: (1) that the Secretary of State comprehensively checks to see whether a proposed name is available for use as an assumed name, and (2) that the Secretary of State's approval amounts to an unassailable grant of exclusive authority to use the approved name.

These conclusions are wrong.... The Secretary of State simply does not have the record or expertise necessary to determine whether a name is actually available for use. Furthermore the Secretary of State's approval does not amount to an absolute grant of rights to use the name. Assumed name statutes serve primarily to protect the public and only secondarily to protect the assumed name. Those who seek exclusive rights to an assumed name must look beyond the statutes.]

To further the point, the Utah Code states that "[t]his chapter does not affect the statutory or common law trademark, service mark, or trade name rights granted by state or federal statute." The name must be either

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2. UTAH CODE ANN. § 42-2-5(1)(a), (b) (1994).
3. Id. § 42-2-5(2).
4. This could be a little confusing since it seems to require every person who will be an owner in the business or who will be conducting the business to execute the document. Such a requirement could be onerous in a partnership with many partners.
"translated into English or transliterated into letters of the English alphabet if it is not in English" and may not:

- contain any words that might convey it is doing another type of business other than the real business of the partnership;
- contain the word "Olympic," "Olympiad," or "Citius Altius Fortius" unless permission was obtained from the United States Olympic Committee;
- have a name that implies it is an agency of the state or any of its subdivisions.

4. Other requirements

Once the partnership name is on file with the Division, the name will stay on file for three years. The partnership should re-file the name with the Division at that time.

If the partnership does not re-file the name after three years, the Division will send a notice to the partnership that the filing of the name has expired. If no new filing is made within 30 days after the mailing of the notice, then the Division will remove the name under file and place it on a permanent inactive alphabetical index.

B. Requirements for a limited partnership name

The rules concerning names of limited partnerships are contained in section 48-2a of the Utah Code. This section covers who may reserve a limited partnership name, how to register a limited partnership name and restrictions in the naming of the limited partnership.

1. Those who can reserve names

According to section 48-2a-103, exclusive rights to a limited partnership name are available to the following:

- any person,
- any domestic limited partnership, or

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8. For example, a partnership should not be named "Scuba Dive for Less" when in fact it is a gun dealership.
10. Id. § 42-2-6.6(6).
11. Id. § 42-2-8.
12. Person, according to section 48-2a-101(12) of the Utah Code, means "an individual, general partnership, limited partnership, limited association, domestic or foreign trust, estate, association, or corporation."
any foreign limited partnership (registered or planning on registering in Utah), or
any person intending to organize a foreign limited partnership that will do business in Utah.

2. **Proper names and proper words for a Utah Limited Partnership**

According to section 48-2a-102 of the Utah Code, each limited partnership shall contain the word “limited partnership,” “limited,” “L.P.,” or “Ltd.” The limited partnership may not, however, contain the name of a limited partner unless it is the name of the general partner or a corporate general partner or if it was the name of the limited partnership before the admission of a new limited partner.\(^{13}\)

The limited partnership name may not include the words “association,” “corporation,” or “incorporated.” It may also not use the words “Olympic,” “Olympiad,” or “Citius Altius Fortius” unless written consent has been received from the United States Olympic Committee.\(^{14}\) In addition the limited partnership name must be “distinguishable”\(^{15}\) from other names used by other businesses doing business in the state.\(^{16}\)

3. **Making the name reservation**

Once a person decides to register the name of the limited partnership, he or she must then file with the Division an application “executed under penalty of perjury”\(^{17}\) requesting the specific name. If the Division finds that the requested name is not in use by any other limited partnership or corporation, it will reserve the name exclusively for the person for 120 days. The name reservation may then be renewed every 120 days.\(^{18}\)

4. **Obtaining the name**

The name belongs to the limited partnership upon the filing of a certificate of limited partnership that complies with Utah Code Annotated section 48-2a-102. However, like a general partnership, the exclusive right to a name in the state of Utah does not really mean exclusive. Section 48-2a-103.5 of the Utah Code states:

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13. **UTAH CODE ANN. § 48-2a-102(1)(b) (1994).**
14. **Id. § 48-2-1102(1)(a).**
15. See section 42-2a-102(5) of the Utah Code for a definition of distinguishable.
16. **UTAH CODE ANN. § 48-2a-102(3) (1994).**
17. Although this section states “under penalty of perjury,” it does not describe it in any further detail.
18. **UTAH CODE ANN. § 48-2a-103(2) (1994).**
The authorization to file a certificate under or to reserve or register a limited partnership name as granted by the Division does not:

(1) abrogate or limit the law governing unfair competition or unfair trade practices;
(2) derogate from the common law, the principles of equity, or the statutes of this state or of the United States with respect to the right to acquire and protect names and trademarks; or
(3) create an exclusive right in geographic or generic terms contained within a name.

In other words, receiving registered authorization to use such a name does not override the public interest that requires fairness in commercial dealings, nor supercedes the established procedures regarding trademark protection, nor confers property rights in the registered name.

C. Who are the partners?

1. Those qualified to be a partner

Because the Utah Uniform Partnership Act ("UPA") defines a partnership as "an association of two or more persons to carry on as coowners [sic] a business for profit," the qualification of partners hinges first on their status as "persons" under the UPA. The UPA broadly defines "person" to include individuals, partnerships, limited liability companies, limited liability partnerships, corporations, or other associations. Certain classes of individuals, however, may be ineligible to become partners. Since partnership is a contractual arrangement, an individual's eligibility generally depends upon his capacity to enter into binding contracts.

2. Those of questionable capacity

a. Minors

The common law rule considers minors capable of entering into a partnership agreement. However, there is a forbidding aspect to the rule: while minors may enjoy all of the rights and powers of an adult partner,

20. Id. § 48-1-1(6).
22. Id.
the law shields them against personal liability to other partners for claims arising under the partnership agreement or to third parties for claims based on contracts made in the ordinary course of partnership business. 23

Nevertheless, the practitioner should remember that no Utah cases on this point currently exist. Moreover, a number of decisions in other jurisdictions have relaxed the rigidity of this rule in order to achieve justice in particular cases. 24 Persons considering entering into a partnership with a minor should consider whether they are willing to be bound by the acts (and hence the judgment) of a minor who may well escape all personal liability to fellow partners for any breach of his or her obligations to them or to the partnership.

b. Mentally incompetent

A second category of persons concerning whom questions of capacity to contract arise are the mentally incompetent. As a general rule, a partnership agreement reached in good faith with a mentally incompetent party for whom a guardian has not been appointed, and whose mental incapacity is neither apparent nor known, is valid until disaffirmed. 25 However, such an agreement is voidable upon the discovery of the mental incompetency, upon which the parties may be restored to their pre-agreement positions. 26

In assessing mental capacity, one should inquire as to "whether the allegedly disabled person possesses sufficient reason to enable him to understand the nature and effect of the act in issue. Even average intelligence is not essential to a valid bargain." 27 A Tenth Circuit case suggests that the practitioner ask whether each of the prospective partners has the capacity 1) "to retain in his memory without prompting" the nature and extent of his contribution to the partnership, 2) "to comprehend how he is disposing of" his contributed money, assets or services, 3) to know to whom he is making his contribution, and 4) to comprehend the kind of consideration he is entitled to receive as a partner. 28

c. Spouses

A third group of potential partners about whom the law has expressed some concern is that of spouses who enter into a partnership with each other. Some states disallow the formation of a partnership that includes both a husband and a wife. However, the substantial majority of states reject this rule. 29 Utah has no case law on this point.

23. Id.
24. Id.
25. Id.
26. Id.
28. Id.
29. BARRETT & SEAGO, supra note 21.
d. Trustees
Trustees may be partners since they are persons. However, trust law may impose some restraint, particularly in view of the potential of unlimited liability.

e. Enemy aliens
One class of persons whose incapacity infrequently arises is that of enemy aliens. When a state of war exists between the United States and the nation of which an alien is a citizen, any partnership in which he is a partner is dissolved or suspended. Where individuals are contemplating the formation of a partnership together, and one of them is a citizen of a nation whose relations with the United States may likely approach hostility in the foreseeable future, they should be advised of the legal consequences of the enemy alien rule.

f. Corporations and financial institutions
As mentioned above, the UPA permits corporations to act as partners. Nevertheless, the wary practitioner will check the articles of incorporation for any restriction on the corporation’s ability to enter into business associations such as a partnership.

Although no Utah case has addressed the issue, a turn-of-the-century United States Supreme Court case held that neither a bank, an insurance company nor a financial institution could be a partner because of a public policy against their “engag[ing] in any [partnerships] save the particular line of business to which they are by name and purpose devoted.”

D. What rights and duties are anticipated for each partner?

I. General partnerships
The UPA provides a number of default rules which define the rights and duties of the partners inter se. Hence, an attorney should ask clients whether they desire to vary from the UPA’s default rules. The following section consists largely of a number of specific questions that address the default rules of the UPA. Note that these rules apply as well to limited

32. BARRETT & SEAGO, supra note 21.
33. Id.
35. BARRETT & SEAGO, supra note 21.
partnerships, except where they conflict with provisions of the Utah Revised Uniform Limited Partnership Act ("URULPA").

a. Rights of partners

Each of the following questions addresses one of the presumed rights of partners under the UPA. Following each question is the position taken by the UPA in the absence of contrary provisions in the partnership agreement.

(1) How do you want the profits of the business to be distributed between the partners?
   • The UPA presumes that partners will share equally in the profits of the business.

(2) Do you intend for partners to receive repayment of their contributions? If so, to what extent and by what means?
   • The UPA presumes that partners have the right to receive repayment of their contributions.

(3) How, if at all, shall partners be indemnified for payments made for the partnership?
   • The UPA presumes a right of partners to be indemnified for payments made for the partnership.

(4) Do you want partners to receive interest on any advances or loans made to the partnership? If so, at what rate?
   • The UPA presumes that partners will receive interest on advances made to the partnership.

(5) Which partners will share in the management of the business? How will the various responsibilities of management be divided among the managing partners?
   • The UPA presumes that partners will share equally in the management of the partnership business.

(6) Do you want partners to have the right to examine partnership books and records?
   • The UPA presumes that partners have the right to examine partnership books and records.

(7) Do you want partners to have the right to a periodic formal accounting? If so, at what intervals—annual, semi-annual, quarterly, etc.?

37. Id. § 48-1-15(1).
38. Id.
39. Id. § 48-1-15(2).
40. Id. § 48-1-15(3).
41. Id. § 48-1-15(5).
42. Id. § 48-1-16.
The UPA presumes that partners have the right to an accounting made at the end of each fiscal year.43

May partners, without dissolving the partnership, transfer any more of their partnership interests than merely the right to a pro rata share of partnership profits without dissolving the partnership?

By the terms of the UPA, in the absence of an agreement to the contrary,

"[a] conveyance by a partner of his interest in the partnership does not of itself . . . entitle the assignee during the continuance of the partnership to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled."44

b. Duties of partners

Each of the following questions addresses one of the presumed duties of partners under the UPA. Following each question is the position taken by the UPA in the absence of contrary provisions in the partnership agreement.

(1) Do you want each partner to be obligated to contribute on a pro rata basis toward the losses of the partnership?

The UPA presumes that each partner has a duty to contribute on a pro rata basis toward the losses of the partnership.45

(2) Do you want any or all of the partners to agree to work for the partnership without salary?

The UPA presumes that partners receive no salary for their work for the partnership.46

(3) Do you want partners to be governed by majority rule in times of disagreement? If so, should majority be determined according to the relative contributions of partners or on a per capita basis?

The UPA presumes that partners will be governed by majority rule in times of disagreement.47

(4) Do you want each (some, any) of the partners to be under a duty to disclose completely to other partners any matters regarding partnership business?

43. Id. § 48-1-19.
44. Id. § 48-1-24.
45. Id. § 48-1-15(1).
46. Id. § 48-1-15(6).
47. Id. § 48-1-15(8).
The UPA presumes that partners must disclose partnership business dealings to other partners.48

(5) Do you want each (some, any) of the partners to account to the partnership for profits obtained by business transactions related to partnership business?

The UPA presumes a duty of the partners to account to the partnership for profits obtained by business transactions related to partnership business.49

(6) Will any property acquired with partnership funds automatically be partnership property?

The UPA presumes that property acquired with partnership funds will be partnership property.50

2. Limited Partnerships

Most of the questions flagged in the foregoing section will apply to general partners in a limited partnership as well as to the partners in a general partnership. Article III of the URULPA discusses the rights of limited partners in connection with their admission to the partnership, voting rights, and inspection of records. The potential liability for partnership obligations to reasonably relying third parties if the limited partner participates in the control of the business is discussed below.

II. Management

A. What type of management structure will the partnership use?

The UPA51 provides for a decentralized management structure; that is, each partner has an equal voice in managing the partnership.52 Regardless of whether the partners’ individual capital contributions or shares of partnership profits and losses are unequal, each partner is entitled to have

48. *Id.* § 48-1-17.
49. *Id.* § 48-1-18.
50. *Id.* § 48-1-5.
51. *Id.* §§ 48-1-1 to -40.
52. *Id.* § 48-1-15(5).
all of the rights of management. This general right to participate in management is the "hallmark of a general partnership." Utah partnerships also enjoy great freedom to establish a different management structure. The management rules provided by the UPA are "default" rules. Thus, for the most part, the management structure and each of the management rights may be altered by agreement among the partners. No management structure is specifically disallowed under


1. The right to information. UTAH CODE ANN. §§ 48-1-16, -17 (1994). “[E]very partner shall at all times have access to and may inspect and copy any of [the partnership books]” and “[p]artners shall render on demand true and full information of all things affecting the partnership to any partner.”

2. The right to conduct business. “All partners have equal rights in the management and conduct of the partnership business.” Id. § 48-1-15(5) (emphasis added).

3. The right to bind the partnership to third parties. Id. § 48-1-6(1). Utah law provides that “[e]very partner is an agent for the partnership for the purpose of its business,” and, thus, “the act of every partner . . . for apparently carrying on in the usual way the business of the partnership . . . binds the partnership.”

4. The right to be involved in making decisions. Utah law provides that disagreements on ordinary matters shall be resolved by vote, and that each partner shall have one vote. Id. § 48-1-15(8), (5).

5. The right to veto specific decisions. Because the following specific actions require unanimity, one partner has the power to veto the decisions:

   (1) admission of a new partner. Id. § 48-1-15(7),

   (2) assignment of partnership property is trust for creditors or in exchange for a promise by the assignee to pay the partnership’s debts,

   (3) disposition of the partnership’s good will,

   (4) confession of a judgment,

   (5) submission of a partnership’s claim or liability to an arbitrator or a referee,

   (6) any action that makes the carrying on of the partnership’s ordinary business impossible, Id. § 48-1-6(3), and

   (7) any action that contravenes a partnership agreement. Id. § 48-1-15(3).

For a more detailed description of management rights, see generally DANIEL S. KLEINBERGER, AGENCY AND PARTNERSHIP ch. 9 (1995).

54. J. WILLIAM CALLISON, PARTNERSHIP LAW AND PRACTICE § 9.01 (1994). Compare the management structure provided by the UPA for partnerships with the centralized management provided by the Utah Revised Business Corporation Act for corporations. A Utah corporation is managed by the board of directors and appointed officers; shareholders do not participate in management. UTAH CODE ANN. §§ 16-10a-801, -831 (Supp. 1997).

55. Again, compare the control and management structure of Utah corporations, which is much more rigid. See id. §§ 16-10a-801, -831.

56. See id. § 48-1-15 (declaring that the rules determining the rights and duties of the partners are "subject to agreement between them"); id.§ 48-1-6(4) ("No act of a partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction.").

57. See supra note 53.

58. A change from default rules, however, does not change the individual liability of the partners for partnership obligations. CALLISON, supra note 54. Note, also, that a partner who does not have the right to bind the partnership to third parties still has the power to do so. Where a third party does not know that the partner’s authority to contract has been restricted by partnership agreement, the partnership will be bound regardless of the restriction. UTAH CODE ANN. § 48-1-
Utah law, so partnership management may "be molded to approximate that of other business entities" if that structure accommodates the needs of the business and the partners. Because Utah law allows such great flexibility, an infinite number of management possibilities exists.

In drafting the partnership agreement, the partners should consider that the partnership will face essentially three areas of decision making: 1) day-to-day ordinary business decisions within the scope of the business, such as hiring and firing policies; 2) long range planning decisions within the context of the operating business, such as business expansion; and 3) decisions involving changes in the fundamental structure and nature of the business (rather than its operation), such as adding new partners and selling assets. The partners should address the issues of who should be involved in each type of decision making and the procedure that should be followed.

Of course, in the absence of a partnership agreement the statutory scheme of equal management rights will apply. Despite the default rule, a partnership who wishes to give all partners an equal voice should explicitly state this intention in writing.

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6(1) (1994). Consequently, the third party will have a valid claim against the partnership. The partnership, however, will have a claim against the partner who acted without authority.

59. HARROCH, supra note 53.

60. FREDERICK G. KEMPIN, JR. & JEREMY L. WIESEN, LEGAL ASPECTS OF MANAGEMENT PROCESS 175 (1969).

61. The UPA default rules do not address decision making in this manner. Instead, the UPA provides certain guidelines. Decisions relating to ordinary matters shall be made by majority vote. UTAH CODE ANN. § 48-1-15(8) (1994). Any act contravening a previous agreement by the partners requires unanimity. Id. Specific decisions that go to the structure of the partnership also require unanimity. Id. § 48-1-6(3), -15(7), -15(8). Section 48-1-6(3) reads in full:

> Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all of the partners have no authority to:
>
> (a) Assign the partnership property in trust for creditors or on the assignee’s promise to pay the debts of the partnership.
> (b) Dispose of the good will of the business.
> (c) Do any other act which would make it impossible to carry on the ordinary business of the partnership.
> (d) Confess a judgment.
> (e) Submit a partnership claim or liability to arbitration or reference. A decision that relates to extraordinary matters that does not contravene a previous agreement by the partners will likely require unanimity as well. See KLEINBERGER, supra note 53, § 9.5.2, at 263-64 (1995).

The UPA provides no dividing line between what matters are ordinary and what are extraordinary, hence, the terms are open to judicial interpretation absent definition in a partnership agreement.

62. CALLISON, supra note 54; MOYE, supra note 53, at 39. In addition, the partnership agreement should address what matters are ordinary and what matters are extraordinary. See supra note 61.
A basic management approach is simply to vary the voting arrangement among or between the partners. Voting power may be allocated according to any factors the partners choose. For example, it may be allocated according to partners' capital contributions, contributions in expertise and skill, or seniority. This management structure allows one or more partners a greater voice in decision making without eliminating the other partners' ability to vote. Management structured in this way accommodates each partner's desire for some control over the business, and, at the same time, allows those that make larger contributions (capital or otherwise) to have greater control.

In addition, the partnership agreement may provide that some partners have veto power over specific decisions, or it may provide varying percentage vote requirements for different matters. For example, the agreement may specify that a change in billing policy will require a fifty-one percent vote, while a change in hiring or firing policy will require a seventy-five percent vote. Likewise, the agreement should specify what partners cannot do without the unanimous consent of the other partners.

A partnership agreement may further limit some partners by denying them the right to vote on certain matters altogether. Although this sort of limitation is generally enforced, it would probably be subject to a narrow interpretation by Utah courts; hence, it should be express and unambiguous.

A partnership agreement may also specify management responsibilities and limitations for each partner. In so doing, a partnership may be able to take advantage of specialized business skills that different partners may possess. One partner may be responsible for the marketing.

63. CALLISON, supra note 54; HARROCH, supra note 53, § 9.03; MOYE, supra note 53, at 68-69.

64. Allocating voting power according to capital contributions is most common. See MOYE, supra note 53, at 69.

65. CALLISON, supra note 54, § 9.02.

66. MOYE, supra note 53, at 41.

67. CALLISON, supra note 54, § 9.03.

68. Id. In at least one well-known case, however, the court's dicta indicates that partners always have the right to consent to changes in the fundamental nature or extent of the partnership, and this right may not be delegated or contracted away. See McCallum v. Ashby, 393 P.2d 774 (Or. 1964). In other words, even though the partnership agreement states that unanimous consent is not required for a particular matter, if that matter goes to the fundamental structure of the partnership, then it is not unlikely that Utah courts will still require unanimous consent.

69. CALLISON, supra note 54, § 9.03; Wilzig v. Sisselman, 442 A.2d 1021, 1030 (N.J. App. 1982) ("The right of a partner to be heard on fundamental and vital aspects of the partnership enterprise, matters that could substantially affect the investment and liability of a partner, should not be deemed surrendered unless the intention to do so is clearly expressed.").

70. Actually, any change from the default rules should be express and unambiguous.

71. MOYE, supra note 53, at 39.

72. See id. at 69.
end, another for the books and accounting, another for manufacturing, and so on. If this approach is taken, it is wise to provide that unusual matters in each of the areas will be decided by all the partners (or submitted to a specific committee). Of course, what constitutes "unusual matters" should also be addressed in the agreement.

A partnership agreement may centralize management by vesting control of some part or all of the business in one or more managing general partners or in a management committee. This approach is particularly useful in larger partnerships, where management by all the partners would be unwieldy. The partnership agreement should designate what authority the managing partner(s) or committee will have and what restrictions will be placed on that authority. The authority delegated should be specified in reasonable detail. In addition, the agreement should state what matters must be decided by all the partners and what percentage vote or whether unanimity will be required of all the partners on those matters. Those drafting partnership agreements must keep in mind that the court will not impose a requirement on which the parties have not agreed.

Unless the partners agree otherwise, managing partners are not entitled to remuneration for their management efforts. Hence, if compensation is desired, the partnership agreement should also specify a salary or salary formula. Furthermore, a partnership may choose to require the managing partner(s) to post a bond for faithful performance.

Another common approach to partnership management structure is frequently found in law firms. These firms consist of two tiers of partners: equity and salaried. The equity partners manage the partnership and share in the profits and losses, while the salaried partners receive a pre-determined draw.

The more common forms of management are listed and discussed above. However, any combination of these basic forms is also acceptable. Regardless of what management form is chosen, the partnership agree-
ment should specify the structure of management and control. It should be explicit as to each partner’s authority and limitations. Matters requiring more than a majority vote as well as those requiring unanimity should be designated. If management duties are clearly and unambiguously set forth in the partnership agreement, the agreement, rather than the default rules of the UPA, will govern.

B. What is the purpose of the partnership?

1. Statement of purpose generally

Utah law does not require that partners set forth, in writing, the purpose or purposes of their business.\textsuperscript{82} Despite the lack of legal requirement, prudence dictates that partners carefully draft a partnership agreement in which they set forth the purpose of the general partnership. The purpose clause in a partnership agreement should express the nature and scope of the business as agreed upon by the partners. The purpose clause defines the scope of the partnership’s business, within which each partner has authority (actual or apparent) to act for the partnership.\textsuperscript{83} Utah law does not limit the type of business that can be carried on in the partnership form, with the exception that the business must be one for profit.\textsuperscript{84} Consequently, the general partnership’s purpose may be expressed in terms that encompass the full range of statutory authority, or in terms that restrict the partnership’s purpose by delineating specific business objectives.

Likewise, Utah law with respect to the limited partnership does not specifically require that partners set forth the purpose or purposes of the business in their certificate of limited partnership.\textsuperscript{85} Despite the lack of legal requirement, Section 101(10) of the RULPA contemplates that a separate limited partnership agreement will be created, which sets forth the purpose of the business.\textsuperscript{86} The purpose clause in a limited partnership agreement should express the nature and scope of the business as agreed upon by the partners. The purpose clause serves to establish the scope of

\textsuperscript{82} Partnership law has not adopted many of the formalities present in the law of corporations.

\textsuperscript{83} SCOTT ROWLEY, ROWLEY ON PARTNERSHIP § 9.0 (2d ed. 1960) (stating that "the scope of a partnership is necessarily largely determined by the partnership contract, but not altogether").

\textsuperscript{84} UTAH CODE ANN. § 48-1-3(1)(a) (Supp. 1997).

\textsuperscript{85} UTAH CODE ANN. § 48-2a-201 (1994).

\textsuperscript{86} Id. § 48-2a-101(10) (defining partnership agreement and stating that, " 'Partnership agreement' means any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business."); see also CALLISON, supra note 54, § 18.01. The 1916 ULPA did not refer to the partnership agreement, and appeared to presume that all important matters concerning the limited partnership affairs would be set forth in the certificate of limited partnership. Id.
the partnership’s business, within which each general partner has authority (actual or apparent) to bind the partnership. Utah law permits a limited partnership broad discretion to “carry on any business, except as otherwise prohibited by applicable provision of the Utah Code.” Consequently, the limited partnership’s purpose clause may be expressed in broad terms or may be restricted to specific business objectives.

2. Specific versus general purpose clauses

A general statement of purpose is more preferable than a specific enumeration. A general purpose clause provides latitude in pursuing a variety of business opportunities and does not force the drafter to predict possible areas of future expansion. On the other hand, a narrow statement of purpose may be used in an effort to limit the authority of the general partners to bind the partnership in transactions with third parties. As general partners in a limited partnership are subject to the same restrictions and liabilities as partners in a general partnership, limiting the scope of the purpose clause may help minimize the general partners’ liability.

Under Utah law, “[e]very [general] partner is an agent of the partnership for the purpose of its business.” As an agent, a general partner may bind the other general partners when the partner “apparently carr[ies] on in the usual way the business of the partnership.” Although potentially subject to waiver by the actual conduct of the parties, a purpose clause in the partnership agreement can help define and limit the scope of the “usual . . . business of the partnership.” Restricting the scope of the business’ purpose minimizes the general partners’ liability for actions of other partners who act outside the described purpose of the business.

In addition to narrowing the purpose clause to limit liability, one commentator has suggested that “in order to restrict the ability of general partners to act beyond the scope of the partnership’s business, the part-

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87. UTAH CODE ANN. § 48-2a-106 (1994).
89. UTAH CODE ANN. § 48-2a-403 (1994).
90. Id. § 48-1-6(1).
91. Id.
92. Id.; CALLISON, supra note 54, § 8.03; see also ROWLEY, supra note 83, § 9.0 (stating that “the scope of a partnership is necessarily largely determined by the partnership contract, but not altogether . . . ’”).
93. MARLIN M. VOLZ ET AL, THE DRAFTING OF PARTNERSHIP AGREEMENTS § 4.03 (7th ed. 1986); cf. CALLISON supra note 54, § 18.11 (“Limiting the scope of the general partners’ agency powers to undertake activities outside the delineated scope of business also provides comfort that the limited partners’ investment will not be used in a manner which was not contemplated or authorized.”).
partnership agreement should [also] . . . state that general partners may not act in any way which is not directly related to such limited business without the other partners’ prior, written consent." Inclusion of this limiting language not only in the partnership agreement but also in the publicly-filed certificate of limited partnership may impart constructive notice to third parties of any limitations on the general partners’ authority. However, the legal effect of including limiting language in the certificate is unclear, and it is likely that courts will find that such language fails to provide third persons with adequate constructive notice.

A narrowly drafted purpose clause may affect a general partner’s liability. However, such a clause will not alter the personal liability of limited partners, as limited partners are generally not liable for the obligations of the limited partnership.

A general partner’s desire to limit liability by narrowing the partnership’s purpose clause should be tempered by the partnership’s desire to permit reasonable expansion of the business without the necessity of amending the partnership agreement. In essence, the purpose clause should be functionable by anticipating reasonable growth and evolution of the business.

A compromise position between a general, broad purpose clause and one which narrowly delineates the partnership’s purpose may be preferable. This purpose clause could state with particularity the businesses that the partnership knows it will conduct and state in general, broad language the activities in which the partnership may at a later date hope to engage.

3. Unauthorized purposes

A partnership formed for illegal purposes or to pursue a lawful purpose in an unlawful manner is invalid and unenforceable. In addition, a contract to form a partnership for the purpose of doing anything forbidden by law is illegal.

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94. CALLISON, supra note 54, § 8.03.
95. Id. at 18-22.
96. UTAH CODE ANN. § 48-2a-303(1) (1994).
97. VORZ, supra note 93.
99. Id.
C. How will the partnership deal with deadlocks and disputes?

1. General partnerships

General partnerships traditionally require that all partners participate in the management of the enterprise. When formed, the interests of the partners are aligned with what is in the best interest of the partnership. Unfortunately, this blissful state of management by unanimous consent can be disrupted by any number of factors: divergent business expectations, changes in the health of the economy, or changes in the financial health of one of the partners, to name a few. Disagreements which may arise can create a deadlock or impasse, particularly in two-partner partnerships, which prevent the enterprise from changing its direction or responding to external exigencies. Although discussing deadlocks is not pleasant, well-advised partners must consider how possible future stalemates will be resolved. Adopting a dispute resolution mechanism at the outset, while the partners are cooperative, will save significant costs and animosity should an impasse arise. While a "disagreement does not have to be violent or continuous to render a partnership ineffective[,] the attrition of repeatedly resolving differences of opinion by arriving at compromises satisfying no one will destroy the partnership just as surely." 100

a. Contexts in which deadlocks may arise

The Utah Code requires that all partners in a general partnership have "equal rights" in the management of the partnership. 101 This clause, which parallels section 18(e) of the Uniform Partnership Act, has been consistently interpreted to allocate voting on a per capita basis, with each partner getting one vote. 102 The result of allocating voting on a per capita basis is the possibility of deadlock in any partnership with an even number of partners, especially given the requirement that all ordinary matters of the partnership be resolved by a majority vote. 103 An evenly divided partnership would be unable to act, and the position of the partnership remains status quo. The problem is especially grievous in a two-member partnership where unanimity will be required for even ordinary matters. 104

101. UTAH CODE ANN. § 48-1-15(5) (1994) ("All partners have equal rights in the management and conduct of the partnership business.").
102. See, e.g., Parks v. Riverside Ins. Co. of America, 308 F.2d 175 (10th Cir. 1962).
103. UTAH CODE ANN. § 48-1-15(8) (1994) ("Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners . . . ").
In addition to the requirement that a majority of the partners control the ordinary matters, the partnership provisions in the Utah Code require the consent of all partners for some actions. These include the assignment of partnership property to secure partnership debts, the disposition of the partnership's goodwill, any act which makes continuation of the partnership's business impossible, confession of a judgment, or submission of a partnership claim or liability to arbitration or reference. Unless otherwise altered, any amendment of the partnership agreement requires the consent of all parties, as does the admission of a new partner. As a result, any single partner effectively has veto power over any of the above actions that the other partners wish to take.

The governing statutes allow the voting requirements and the equal rights requirement to be altered by agreement. Even so, the possibility of deadlock exists if the agreement creates an unreasonable minority in situations in which the agreement requires approval of a super-majority or consent of all partners.

Now that the possibilities of deadlock are apparent, the need to implement a deadlock resolution mechanism into a written partnership agreement becomes paramount when one considers the common law and statutory remedies available to a partner frustrated with a deadlock. In a partnership at will, each partner is vested with the power to dissolve the partnership upon giving clear notice to the other partners. If the partnership is not at will, then dissolution by notice is not available. However, deadlock concerning the manner in which the business is to be conducted is grounds for dissolution by judicial decree since partners are vested with the power to petition the court for dissolution on the basis that the deadlock prevents the accomplishment of the partnership's business purpose. Neither of these remedies is particularly attractive and

106. Id. § 48-1-6(3)(a)-(e).
107. Id. § 48-1-15(8).
108. Id. § 48-1-15(7).
109. Id. § 48-1-15.
110. Graham v. Street, 166 P.2d 524, 535 (Utah 1946) ("A partnership at will may be dissolved by one partner unequivocally bringing home notice to the other partners that he no longer intends to be a partner."); see Callison, supra note 54, § 9.02.
each may impose significant burdens upon all parties as each dissolution vests a partner with a right to an accounting of his interest,112 which usually derives from the sale of all partnership assets and distribution of the proceeds to the partners. However, diligent drafting and a modicum of forethought can provide a less burdensome dispute mechanism.

b. Pre-drafting issues

Each dispute resolution mechanism will need to be drafted and tailored to the particular needs of the partnership and the respective interests of the partners. There are three threshold issues that the drafter should consider before including any of these mechanisms in the partnership agreement.

The first issue is how the partners want to define an impasse or deadlock. This clause opens the door to the use of the mechanisms. The drafter should spend time with the partners, reviewing the deal points and identifying which contingencies pose the highest possibility of detrimental effect upon the partnership. While no drafter can consider all possible contingencies, and no client can pay for a document which would address all possible contingencies, the provision defining deadlock should reflect the nature and purpose of the partnership, any possible changes in the assumptions upon which the deal was constructed, and considerations for rough economic times. This provision should be drafted to avoid the conundrum of being deadlocked over whether an impasse falls within the deadlock provision.

The second issue is one of timing. It should be clear in the partnership agreement at what stage of the dispute the deadlock resolution provisions may be invoked. One popular addition to partnership agreements is a cooling-off period during which neither party may resort to any dispute resolution mechanism. The purpose of the cooling-off period is that time will allow emotions to subside and cooler heads to prevail, with the hope that an amicable resolution can be reached. However, the provision should provide for expedited resolution if a decision must be made within the cooling-off period to prevent the partnership from being materially prejudiced. Neither party should be able to use the cooling-off period as means to force its will upon another.

A final consideration must be the severity of the mechanism itself. There are two divergent theories. First, if the dispute resolution mechanism is constructed to operate in such a manner as to leave both parties worse off than without resorting to it, then the theory is that the mechanism functions not by its operation; rather, the threat of its operation

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tends to force the divergent camps to reach resolution before it is in­
voked. As a practical matter, the absence of a deadlock resolution pro­vi­sion in the partnership agreement produces this result: assuming all con­cerned realize that the ultimate remedy is dissolution, its severity would tend to persuade the parties at loggerheads to reconcile for the sake of the continuation of the partnership. On the other hand, the second theory rec­ognizes that the partners may want the mechanism to provide the most equitable result with the least hassle.

c. Dispute resolution mechanisms

   Litigation. Litigation need not be included in the agreement, but it is included here to demonstrate its limitations. As a general rule, partners cannot sue other partners or the partnership before an accounting of the partnership interests.113 This limitation is not subject to alteration in the partnership agreement.

   Arbitration. Possibly the simplest mechanism is to have the partners agree to submit the impasse to an arbiter or an arbitration panel for reso­lution.114 As appealing as this may sound, significant issues must be re­solved before the drafter inserts a boilerplate arbitration clause. The ben­efits of arbitration are well known and substantial. The resolution is usu­ally cheaper than traditional litigation. Disputes are not in the public re­cords. In some cases the arbiter may have particular expertise which aligns his decision the expectations of the parties rather than splitting the baby down the middle. However, there are disadvantages to arbitration as well. The agreement, by compelling arbitration, may prevent a partner from resorting to a court for preliminary injunctions or restraining orders. If the arbitration is binding, a partner’s ability to appeal the arbiter’s deci­sion is restricted. If non-binding, appeal may hamper arbitration’s benefit as a rapid resolution mechanism by removing any finality from the deci­sion until after the time to file an appeal has expired. More significantly, the partners may not wish to commit significant issues to an arbiter who will not spend the time necessary to understand the concerns and complex relationships of the parties.115

   The provision must also address which issues can be submitted to arbitration. There are some issues that lend themselves to arbitration, and

113. 59 AM. JUR. Partnership § 542 (1987). The partner’s actions against other partners in the partnership are limited to actions at law. Id. § 599. Equitable remedies available to a partner include dissolution, settlement of partnership accounts and division of partnership assets in an accounting, specific performance, reformation, rescission, or cancellation of partnership contracts. Id.


115. McKnight, supra note 100, § 5.8.2.
these usually concern the valuation of partnership assets, calculating the value of capital accounts, and appraising the value of a partnership interest. Many investors, however, may be reluctant to submit significant issues to arbitration. One approach is to make the arbitration clause as broad as possible, or at least broad enough to allow the arbiter to consider whether a particular issue is or is not properly subject to arbitration.\textsuperscript{116}

The clause must either choose or provide a mechanism for choosing an arbiter or arbitration panel. Agreeing on an arbiter at the outset is the simplest and least expensive option. Another technique requires each party to choose an arbiter. The group then chosen designates another, who is not a member of the group, to hear the disagreement, or the group can hear the conflict as a panel.\textsuperscript{117} Finally, the agreement must select rules by which the arbitration proceeding will be governed.\textsuperscript{118}

\textit{Mediation.} A mediation provision would provide that the parties enter into good faith negotiations. The role of the mediator would be to smooth the way, reconciling the parties' differences in an attempt to reach a compromise.\textsuperscript{119} The mediation clause, like the arbitration clause, must either name a mediator or provide a mechanism for naming one. The most significant downside of mediation is that there is no means of enforcing any agreement reached by the parties.\textsuperscript{120}

\textit{Referee.} In some cases, the partners may want to nominate a neutral person, or perhaps three people, to serve as an informal referee to decide the issue in dispute. Unlike a mediator, a referee would not go back and forth between the deadlocked partners seeking to bring them to a meeting of the minds; rather, the referee would have the power to dictate how the dispute should be resolved. In effect, the partners would agree in advance to accept the decision of the referee and to act as partners in accordance with that determination. In other words, no partnership rights, fiduciary duties, or liabilities to third parties should be assigned directly to the referee. The referees can be selected either in advance or after the deadlock has arisen; but if the partners do not agree upon a referee early enough, it may prove just as difficult to reach a consensus on this decision as on the underlying issue that caused the deadlock.

\textit{Buy-sell agreement.} Buy-sell agreements are dispute resolution mechanisms in the sense that the dispute is resolved by removing one of the warring parties from the entity. Their use is most effective where the part-

\begin{footnotes}
\item[116.] \textit{Harroch}, supra note 53, § 7.16(3)(a).
\item[117.] \textit{Id}.
\item[118.] \textit{Id}. Standard provisions governing arbitration proceedings are issued by the American Arbitration Association and the International Chamber of Commerce.
\item[119.] \textit{Id}. § 7.16(2)(a).
\item[120.] \textit{Id}.
\end{footnotes}
partnership consists of only two partners, and they are widely used in joint venture agreements. One party selects a price at which it values an interest in the partnership. Then, the other party has the option of either putting or selling its interest to the party that selected the price, or purchasing the remaining interest at the set price. This mechanism purports to provide an equitable result. If the price is high, the partner may sell; if low, then the partner may purchase the interest. However, the possibility for abuse exists when the partner with the option to sell or purchase does not have ready access to liquid assets with which to make the purchase. This allows the price-setting partner to bid not at a fair price, but at a price just beyond that which the other partner could afford.

**Buy-out provision.** A buy-out provision in the partnership agreement will grant to the parties either the right to purchase the interest of other parties or the right to put or sell a partnership interest to other parties. This mechanism, like the buy-sell agreement, resolves the dispute by removing one of the competing interests from the partnership.

A buy-out provision is probably the most complex means of resolving the impasse. The drafter must consider how the value of the interest is going to be determined. Common choices include the following: appraisal by a single appraiser; arbitration following the baseball model, where each party makes a valuation, and the appraiser/arbitrator chooses one; each party selects an appraiser, and if the individual appraisals are comparable, an average will be the resulting price; otherwise, an additional appraiser (selected by the previous appraisers) will make the determining appraisal; or the parties may agree on a formula based upon book value, earnings, profit, or receipts.

Both the buy-out agreement and the buy-sell agreement have the potential for adverse tax consequences to both the partners and the partnership. As a result, the drafter must consider whether the partnership or the other partner(s) are going to be the purchasers and how the purchase can be financed. Additionally, care must be taken to prevent the transfer of fifty percent or more of the partnership interests within a 12 month period, as this will terminate the partnership for tax purposes.

**Transfer.** A right of transfer is a right vested in one of the competing parties where, upon deadlock, the partner can sell its interest to a third party. This resolution may not be as effective as the others for a number of reasons. First, the disposition may not be rapid enough to place the management rights associated with the interest in the hands of a party.

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121. *Id.* § 7.17(5)(a).
122. McKnight, *supra* note 100, § 5.2.2.
123. *Id.*
more agreeable to the remaining partner(s) before the partnership must act. Second, the entrance of a new partner into the partnership requires the consent of all partners. This limits those to whom the selling partner may shop his interest. Finally, the effects of the transfer on the partnership may be more devastating than the impasse. The sale may put the partnership over the fifty percent threshold of transferred shares which causes a termination of the partnership. The sale may also trigger any due on sale clauses to which the partnership is subject.

2. Limited partnership

The possibility for deadlock in a limited partnership exists in two different contexts. The first arises when the partnership has more than one general partner. In that case the limited partnership agreement (or certificate) should adopt the deadlock resolution mechanisms that would be applicable to a general partnership for resolving disputes between general partners. Mechanisms for resolving deadlocks include arbitration, mediation, buy-sell provisions, buy-out provisions, and transfer rights. These mechanisms will be discussed briefly below.

The second context in which deadlocks arise involves limited partners. Here, two characteristics inherent in a limited partnership tend to mitigate deadlocks between a general partner and a limited partner or between limited partners. First, limited partners cannot participate in the control of the limited partnership if they wish to retain their limited liability. Second, in most limited partnerships, the limited partnership interests are freely transferable. Thus, if a deadlock does arise, the easiest resolution would be to have a limited partner sell his or her interest. This is a much more practical solution in this context where the interest is more of a passive investment as opposed to a sale of a general partnership interest which probably has restrictions on transfer and usually requires some participation in management.

Deadlocks may arise in several situations within a limited partnership. For instance, the Utah Code provides the following issues in which a limited partner can vote without exercising control:

- The dissolution and winding up of the limited partnership.
- The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership.
- The incurrence of indebtedness by the limited partnership other than in the ordinary course of its business.

125. Id.
126. UTAH CODE ANN. § 48-2a-303(1) (1994) (stating that "a limited partner is not liable for the obligations of the limited partnership unless . . . in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business . . . ").
• A change in the nature of the business.
• The admission or removal of a general partner.
• The admission or removal of a limited partner.
• A transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners.
• An amendment to the partnership agreement or certificate of limited partnership. 127

In every situation listed above, a deadlock is possible. In addition, in certain circumstances, the consent of all partners is required before a general partner can withdraw from the partnership. 128 Again, a deadlock is possible.

When no provision for resolving impasses is included in the certificate or the limited partnership agreement and the deadlock is so significant that "it is not reasonably practicable to carry on the business in conformity with the partnership agreement," either a general or limited partner can petition a court for dissolution. 129

As mentioned above, the easiest dispute resolution device is the free transferability of the limited partnership interest. Other possible deadlock resolution mechanisms exist, such as arbitration and mediation. Where the dispute is between a general partner and limited partners, then the certificate or the partnership agreement could provide one party with a springing vote to be exercised in the event of deadlock. If the interests are not freely transferrable, then the limited partnership agreement could provide the following: a buy-sell provision in which one party selects a price and the other has the option to either purchase the price-setter’s interest or to sell the interest to the price-setter at that price; a buy-out provision in which the partnership or other partners would purchase the interest of the competing partner; or a means to lift the restriction on the transfer of the limited partnership interest. Each of these possibilities raises tax issues, issues of compliance with the Utah Revised Limited Partnership Act (specifically regarding the admission of new partners), price determination issues, and issues regarding how the transfer may be financed.

127. Id. § 48-2a-303(2)(f)(i)-(viii).
128. Id. § 48-2a-402(4)-(10). It should be noted, however, that the events of withdrawal that do not require consent are so broad that they practically swallow the rule. The general partner can withdraw upon providing notice to all other partners. Id. §§ 48-2a-402(1), 48-2a-602. In such a case the recourse available to the remaining partners is limited to damages suffered if the withdrawal violated the limited partnership agreement. Id. § 48-2a-602. The general partner can also withdraw by assigning his or her partnership interest if not prohibited by agreement. Id. §§ 48-2a-402(2), 48-2a-702.
129. Id. § 48-2a-802; see Nupetco Assoc. v. Jenkins, 669 P.2d 877 (Utah 1983) (applying the same standard to a general partnership deadlock).
D. How will the partnership handle banking?

In a general partnership, each one of the partners has the actual authority to bind the partnership, so any one partner could unilaterally choose a bank and open an account. However, the bank officer may require some indicia of the partner's ability to represent the partnership. To best resolve this problem the partnership should allow the partner to take a copy of the partnership agreement to the bank. That may be sufficient, but, as explained above, the majority of all partners is required to approve any ordinary matters of the partnership where differences exist. The more prudent method would have the partners agree on a bank and the number and type of accounts to be opened, provide a document memorializing the decision, and nominate one of their members to perform the function.

In the case of a limited partnership, the partnership will need to choose a bank and establish bank accounts. This is one of the areas in which the limited partners have no right to any input if they wish to retain the shield of limited liability. The general partner has actual authority to act on behalf of and bind the partnership. As a result, the general partner has the sole voice in choosing the bank and opening accounts. The bank will wish to see some evidence of the general partner's authority. This can be met by showing the bank officer either a copy of the certificate or a copy of the limited partnership agreement.

E. The Annual Meeting

An annual meeting in a general partnership without centralized management may be somewhat redundant since the general rule is that each partner in a general partnership is obliged to participate, or at least has equal right to participate in the management of the partnership. If the presumption is that all partners are participating in daily management, then an annual meeting may be required solely as a review of the year past and a survey to determine whether any changes in the projected course of the enterprise are warranted. However, no provision in the partnership agreement is required to call such a meeting, nor are the purposes it may serve limited to a yearly meeting of the partners.

For a limited partnership, annual meetings are not required under URULPA. The Act does require, however, that the limited partnership file an annual report with the Division of Corporations and Commercial

130. UTAH CODE ANN. § 48-1-6 (1994).
131. Id. § 48-1-15(8).
132. Id. §§ 48-2a-403, 48-1-6; see Harline v. Daines, 567 P.2d 1120, 1124 (Utah 1977).
Code of the Utah Department of Commerce. Consequently, requiring an annual meeting in the limited partnership agreement may be a good idea. The annual report can be reviewed, and the general partners could accept input from the limited partners regarding the conduct of the business. The decision should also be based on the following factors: the relationship between the limited partners and the general partner, the relationship between the limited partners themselves, the nature of the business being undertaken, and the expertise of the limited partners in that business. Whether the partnership will require an annual meeting should be determined at the outset.

Whether or not the limited partnership agreement provides for an annual meeting or any other meeting, the drafter must include the requirements for calling a meeting. The requirements should include provisions requiring notice of the meeting, who gets notice, the form and timing of the notice, waiver of notice, who may call the meeting (usually either a general partner, a limited partner, or a group of limited partners with a threshold ownership amount), quorum requirements, and the use and form of proxies.

F. How much power or control will the limited partners retain?

Utah law provides that, in general, a limited partner will not be liable for limited partnership obligations unless "he participates in the control of the business." Thus, a limited partner who has no control over the partnership will not be personally liable to partnership creditors. This rule, often called the control rule, creates a "tension between the desires of limited partners to have a significant role in partnership decisions and their desires to avoid general liability." Although Utah law

134. Id. § 48-2a-210.
135. Id. § 48-2a-303(2)(b), (e). The limited partner could request a meeting without "exercising control." Id. § 48-2a-303(e).
137. The Utah Revised Limited Partnership Act provides other instances in which a limited partner may be liable for limited partnership obligations, but those instances are not relevant to the current discussion. See UTAH CODE ANN. § 48-2a-303(4) (1994) (stating that limited partners "who knowingly permit [their] name[s] to be used in the name of the limited partnership" may be liable to creditors).
138. Id. § 48-2a-303(1). In order to recover from a limited partner, however, a creditor must have reasonably believed, based on the limited partner's participation, that the limited partner was in fact a general partner. Id.
139. Limited partners are generally only liable to the extent of their agreed upon contributions to the partnership. CALLISON, supra note 54, § 22.01; HARROCH, supra note 53, § 6.11[1]. In this sense, a limited partner is in a position similar to that of a corporate shareholder. CALLISON, supra note 54, § 22.01.
140. HARROCH, supra note 53, § 12.07[1].
does not specifically prohibit limited partners from participating in a partnership's management, the threat of personal liability understandably detters such participation.¹⁴¹

The control rule also poses serious drafting considerations. If the limited partnership agreement retains too much power or ultimate control for limited partners, those partners may lose their limited liability. At the same time, the limited partners may wish to retain as much control over their investments as possible. Retaining "reasonable investor supervision"¹⁴² while avoiding the control rule trap can be a difficult undertaking.¹⁴³ Fortunately, the Utah Revised Limited Partnership Act provides a safe harbor under which extensive rights can be granted to limited partners without fear of liability.¹⁴⁴ However, to the extent that limited partners are allowed a voice in partnership affairs, the partnership agreement should carefully circumscribe the participation granted in order to prevent the limited partners from crossing the control threshold.¹⁴⁵

A limited partnership agreement may safely grant certain voting rights to limited partners.¹⁴⁶ Specifically, limited partners may have the power to vote on extraordinary matters affecting the limited partners' investments.¹⁴⁷ Limited partners may also propose those matters for a vote.¹⁴⁸ Extraordinary matters include amending the partnership agreement or certificate of limited partnership, removal or admission of general or limited partners, transfer of substantially all the partnership's assets, termination of the partnership, changes in the nature of the partnership's business, debt incurred by the partnership other than in the ordi-

¹⁴¹. See CALLISON, supra note 54, § 22.03.
¹⁴². Id. § 22.17.
¹⁴³. Several commentators have noted that "[p]robably the most serious problem encountered in drafting and carrying out a limited partnership agreement is that of determining what constitutes taking part "in the control of the business" of a limited partnership." Joseph J. Basile, Jr., Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule, 38 VAND. L. REV. 1199, 1221 (1985) (quoting Coleman & Weatherbie, Special Problems in Limited Partnership Planning, 30 S.W.L.J. 887, 897 (1976)).
¹⁴⁴. The safe harbor is found in section 48-2a-303(2) of the Utah Code. Note that the safe harbor itself does not grant any rights to limited partners. The default management structure of a limited partnership under the Utah Revised Limited Partnership Act is very simple from a limited partner's perspective: the general partners manage. UTAH CODE ANN. § 48-2a-403 (1994). The limited partners are essentially passive. Any control rights given to limited partners must, therefore, be granted in the limited partnership agreement. CALLISON, supra note 54, §§ 21.03, 22.19.
¹⁴⁵. CALLEON, supra note 54, § 22.03.
¹⁴⁶. UTAH CODE ANN. §§ 48-2a-302, -303(2)(f) (1994). Voting power may be allocated among the limited partners on a per capita basis or according to capital contributions, or it may be allocated some other way. CALLISON, supra note 54, § 21.03.
¹⁴⁸. Id. §§ 48-2a-302, -303(2)(f).
The limited partnership agreement may provide for unanimous consent of the limited partners or for a supermajority on any of the extraordinary matters. By holding the power to vote on extraordinary transactions, the limited partners of a partnership retain ultimate control over whether those transactions take place because the general partner is forced to obtain the limited partners' consent before going forward.

The safe harbor also provides that limited partners may have the power to vote on "matters related to the business of the limited partnership . . . which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners." It would appear that by stating in a written partnership agreement that limited partners retain the right to vote on every business decision, limited partners could exercise unlimited control over the partnership without liability. However, it seems more likely that the provision was "intended to enable limited partners to obtain the right to propose or to veto transactional decisions specified in the agreement, such as entering into a lease, transferring an asset, or making a loan," i.e., specific transactions that would not otherwise fit under the safe harbor because they do not qualify as extraordinary.

The safe harbor also allows limited partners to have some participation in the ordinary business of the partnership. The limited partners may freely advise and consult the general partner on business matters. In larger partnerships, this is often done through a limited partners advisory board. The limited partners elect a board that is responsible for communicating with the general partner and monitoring the general partner's

149. Id.
150. CALLISON, supra note 54, § 21.03.
152. See Kenneth L. Bennight, Jr. & Troy S. Martin III, Limitation of Liability of Limited Partners While Affording Control of Partnership Affairs to Limited Partners, 22 ST. MARY'S L.J. 5 (1990) ("A literal reading of this section would allow limited partnership agreements which permit limited partners to exercise complete control over the partnership while still being protected against unlimited liability, without regard to creditor reliance.").
154. UTAH CODE ANN. § 48-2a-303(2)(b) (1994). Limited partners may, nevertheless, have personal liability if, rather than advising, they are actually instructing the general partner. CALLISON, supra note 54, § 22.05. Whether the limited partners' actions will be deemed advice or instruction depends on the facts surrounding the actions. For example, if the limited partners exert financial leverage at the same time, it is likely the action will be deemed instruction and not merely advice. See id.
155. HARROCH, supra note 53, § 12.12.
actions. The board may be given the power, on behalf of the limited partners, to approve or disapprove specific actions. 156

Limited partners may attend partnership meetings and may also request that such meetings be held. 157 Consequently, limited partners may propose certain actions and then ensure that the proposal is discussed among the general partners. Of course, the limited partners may advise the discussion. Short of making the decision themselves, the limited partners may thus be allowed to participate in the entire decision making process. Also, participation in partnership meetings may help keep limited partners abreast of partnership business and recent developments.

Limited partners may also serve as employees of the partnership or as officers or directors of a corporate general partner, and the fact of such service, alone, will not violate the control rule. 158 However, additional factors of control, in combination with such service, may take those limited partners outside the safe harbor provision. 159

The safe harbor further allows limited partnership agreements to grant limited partners the power to bring derivative actions on behalf of the partnership 160 and to participate in the winding up of the partnership. 161 In addition, a limited partner may act as a surety for the partnership or guarantee specific partnership obligations 162 without violating the control test. 163

Utah law provides that limited partners may exercise powers other than those discussed above without necessarily "participat[ing] in the control of the business." 164 In other words, the safe harbor provision is not an exhaustive list of limited partner powers that will not violate the

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156. Id.
158. Id. § 48-2a-303(2)(a).
159. See id. § 48-2a-303(2) (stating that a limited partner does not violate the control rule "solely by doing one or more of the following"); CALLISON, supra note 54, §§ 22.13, 14. For example, if a limited partner acting as an employee of the partnership "is not subject to a general partner's direction and control," he/she will probably be found to be participating in the control of the business. H. Similarly, where a limited partner is also an officer or director of a corporate general partner, and the corporate general partner is not adequately capitalized or corporate formalities are not observed, the control test will likely be found violated. See id.; cf. Bergeson v. Life Ins. Corp. of America, 170 F. Supp. 150 (D. Utah 1958), modified, 265 F.2d 227 (10th Cir.), cert. denied, 360 U.S. 932 (1959) (finding limited partners personally liable under prior Utah partnership law where the only business of the partnership was to organize and operate the corporation and where the limited partners served as corporate officers and directors, contributed services in exchange for partnership interests, and failed to swear to the certificate of limited partnership).
161. Id. § 48-2a-303(2)(g).
162. Id. § 48-2a-303(2)(c).
163. Obviously, a limited partner who acts as a surety for or guarantees any partnership obligation will have personal liability for that obligation.
control rule. Nevertheless, any additional powers granted to limited partners fall outside the safe harbor, and thus whether such powers violate the control rule is subject to great uncertainty.

Because the penalty for incorrect conclusions in this regard is serious, the best approach is to assume that the limited partners will become liable for additional participation. Nevertheless, if the limited partners desire added participation, the limited partnership agreement may require a judicial finding or opinion of counsel that the actions will not make the limited partners personally liable.

A final note of caution: if a limited partnership intends to do business in states other than Utah, the drafters of the limited partnership agreement need to be aware of more restrictive provisions regarding limited partner rights in those other states.

III. Tax Planning and Financial Accounting

A. Which taxable year will the partnership use?

In order to appropriately determine taxable income, a tax period must be established. The term "taxable year" means the calendar year or fiscal year upon which taxable income is computed. The choice of a taxable year is significant because it may determine the effective rate of tax, the applicability of new legislation, the timing of tax payment, and the ability to defer taxes to one or more of the partners due to the differences in the taxable years of the partnership and the partners.

The partnership's ability to defer taxes at the partner level is restricted by the Internal Revenue Code. The partnership must use the "majority interest taxable year" if there is one. The "majority interest taxable year" is the taxable year of one or more partners with more than fifty percent of the total interest in partnership capital and profits. If no
majority interest taxable year exists, the taxable year of all the principal partners must be used.  

If neither of the preceding rules apply, the partnership must adopt the taxable year used by one or more of the partners that results in the "least aggregate deferral of income to the partners." This is determined by multiplying each partner's proportionate share in the partnership by the number of months of tax deferral that would be obtained by selecting a given taxable year and totaling the result obtained for each partner. The taxable year that results in the lowest number is the taxable year that must be adopted.

B. Which accounting method will the partnership use?

The choice of which accounting method to use is very important to a business because it determines when income, expenses, and deductions are recognized. The accounting method used by the taxpayer in keeping his books determines the method to be used for determining taxable income as long as it clearly reflects income. The Internal Revenue Code ("I.R.C.") authorizes the use of the "cash receipts and disbursements method," an accrual method, methods authorized for special types of taxpayers, and any combination of these methods permitted by the regulations.

The cash method does not take items into income until they are actually or constructively received. Similarly, expenses are deducted in the taxable year in which they are paid.

The accrual method takes items into income as soon as the right to receive the income is fixed and the amount of the income can be determined with reasonable accuracy. At the same time, expenses are deducted in the taxable year in which the liability is fixed and the amount can be determined with reasonable accuracy.

176. Id. § 706(b)(1)(B)(ii). Principal partners are those partners who have more than a five percent interest in the capital and profits of the partnership. Id. § 706(b)(3).
178. Id.
181. Id. § 446(b).
182. Id. § 446(c)(1).
183. Id. § 446(c)(2).
184. Id. § 446(c)(3).
185. Id. § 446(c)(4).
187. Id.
188. Id. § 1.446-1(c)(1)(ii).
189. Id.
Partnerships are prohibited from using the cash method of accounting when any partner is a C corporation\(^\text{190}\) and when the partnership is a tax shelter.\(^\text{191}\) A partnership is a tax shelter when: 1) sales of partnership interests have been subject to the registration requirements of state or federal security laws; 2) more than thirty-five percent of partnership losses are allocated to limited partners who do not actively participate in partnership management; or 3) the partnership’s principal purpose is to avoid or evade federal income tax.\(^\text{192}\)

Once an accounting method is chosen, it is very difficult to change it. The consent of the Secretary of the Treasury to the change is required before it will be effective for tax purposes.\(^\text{193}\)

C. What inventory costing method will the partnership use?

If the partnership will have inventory, a method of tracking the costs of inventory must be chosen.\(^\text{194}\) This method must conform as nearly as possible to the “best accounting practice in the trade or business” and clearly reflect income.\(^\text{195}\) Inventory tracking methods include two components: 1) the value that should be attached to inventory, and 2) the method to be used to track the flow of inventory.

1. Inventory valuation

Inventory is generally valued at cost or at the lower of cost or market.\(^\text{196}\) For purchased inventory, cost is the purchase price plus any transportation and other necessary acquisition costs.\(^\text{197}\) For manufactured inventory, cost is the cost of raw materials, direct labor, and indirect costs allocable to the production of the inventory.\(^\text{198}\)

When the lower-of-cost-or-market-value method is used, inventory is valued at the lower of its cost or its market value.\(^\text{199}\) When inventory prices fall, this method will result in a higher cost of goods sold because

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\(^{190}\) I.R.C. § 448(a)(2) (1994). There are two exceptions to this rule. First, a corporate partner that is a qualified personal service corporation will be treated as an individual. Id. §§ 448(b)(2), (d)(2). Second, if the partnership has gross receipts of less than $5,000,000, it will not be prevented from using the cash method of accounting for having a C corporation as a partner. Id. §§ 448(b)(3), (c).

\(^{191}\) Id. § 448(a)(3).

\(^{192}\) Id. §§ 448(d)(3), 461(f)(3).

\(^{193}\) Id. §§ 446(e), 7701(11)(B).


\(^{195}\) I.R.C. § 471(a) (1994).


\(^{197}\) Id. § 1.471-3(b).

\(^{198}\) Id. § 1.471-3(c).

\(^{199}\) The market value is essentially the cost that would be incurred to produce or acquire the inventory at the date the inventory is to be valued. Id. § 1.471-4(a)(1).
the inventory remaining at the end of the year will have a lower value. This will lower taxable income.

2. **Inventory flow tracking**

Because businesses will usually acquire inventory at different prices a method must be used to determine which inventory has been sold. There are four primary methods used to track the flow of inventory: specific identification, FIFO, LIFO, and weighted cost of goods sold.\(^{200}\)

   a. **Specific identification**

   When this method is used, each piece of inventory is tracked separately. This requires that records must be kept for each specific piece of inventory. When inventory is sold, the cost of the specific piece(s) of inventory is used to determine the cost of goods sold. As this requires that each piece of inventory be tracked separately, this method is only practical if the inventory consists of unique or easily identifiable, relatively expensive items.

   b. **FIFO**

   FIFO (First in First Out) assumes that, when inventory is sold, the piece of inventory that was acquired first is the first piece sold. In rising markets, this method will result in a lower cost of goods sold than the other methods and, consequently, a higher taxable income.

   c. **LIFO**

   LIFO (Last in First Out) assumes that, when inventory is sold, the most recently acquired piece of inventory is the first piece sold. In rising markets, this method will result in a higher cost of goods sold than the other methods and, as a result, a lower taxable income.\(^{201}\)

   d. **Weighted cost of goods sold**

   This method averages the cost of all inventory. This results in a cost of goods sold and taxable income that is in between that determined under the other methods. This method requires that each time inventory is acquired, the value of the inventory is adjusted. In many situations, this will make the book work more difficult and time consuming.

D. **How will capital accounts be set up?**

Unless otherwise provided, each partner is entitled to an equal share of the profits and surplus after all liabilities of the partnership have been paid.\(^{202}\) This means that unless the partnership agreement states other-

\(^{200}\) The method chosen should be applied consistently to the entire inventory. *Id.* § 1.471-2(d).

\(^{201}\) Because of this, section 472 of the Internal Revenue code limits the use of this method.

wise, all items of income or loss and all entitlements or obligations will be shared equally. Usually this is not the desired result, for partners normally wish to share profits and losses in proportion to each partner’s contribution to the partnership, however that may be defined. The partnership agreement should specify how the contributions of each partner will be credited on the books of the partnership, what will increase or decrease those credits, and what effect those entries will have. So long as these allocations are made at arm’s length, do not involve family members, and reflect substantial economic realities, the partners may decide among themselves how they will keep their books and records, for purposes of distributing current gains or losses, sharing long term appreciation or depreciation, and determining capital accounts for purposes of liquidation or termination.

E. Will the family partnership provisions apply?

Partnerships are often used to split income among family members and to facilitate estate planning. Partnership interests transferred by one family member to another or donated by a partner are subject to special provisions to determine if the income produced by the transferred partnership interest will be recognized as belonging to the recipient for tax purposes.

Ownership of the partnership interest will be recognized if the recipient is the true owner of the property. This requires that dominion and control be vested in the donee. Transfer of legal ownership is not sufficient if the conduct of the parties indicates that the recipient is not the true owner of the property.

If capital is a material income-producing factor, the partnership income distribution will be recognized if 1) capital is a material income-producing factor, 2) reasonable compensation is paid to the donor, and 3) the income attributable to the donee’s capital is not proportionately greater than the income attributed to the donor’s capital.

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203. Partnership interests purchased by one member of a family from another will be treated as if they were created by gift. I.R.C. § 704(e)(3) (1994).
204. Id. § 704(e); Treas. Reg. § 1.704-1(e) (1994).
206. Id. § 1.704-1(e)(2)(i).
207. Id. § 1.704-1(e)(1)(iv).
Contributions of property to a partnership under section 721(a) of the I.R.C. result in nonrecognition of gain or loss to the partner if the contribution is, in fact, property and it is transferred to the partnership in exchange for a partnership interest. The contribution of services, however, will not qualify for nonrecognition treatment and a taxable event will occur as a result of such services being rendered in exchange for an interest in the partnership. Additionally, if the partnership serves as a mere investment vehicle, the contribution of property will trigger a taxable event. In any event, since any income, gain, loss, or deduction with respect to property contributed to the partnership must be shared in such a way as to take into account any variation between the contributing partner's basis in the property and its fair market value at the time of contribution, I.R.C. section 704(c)(1) and other restrictions apply.

G. When are special allocations appropriate and how should they be made?

Subchapter K of the I.R.C. applies to businesses conducted as a partnership for tax purposes. Partnership income is taxed to the partners at the time the income is earned, whether distributed to the partners or not. The flexible allocation rule of section 704 allows partners to allocate among themselves certain income, deductions, and credits pertaining to the partnership's operations. The IRS will respect these special allocations if they have substantial economic effect. If they do not have substantial economic effect, then the IRS will allocate the items according to the partnership agreement.
ing to the partners' actual economic interests reflected in the partnership agreement. 215

Whether partners should make special allocations and whether it is desirable for those allocations to be respected under section 704(b) will depend upon the partners' economic objectives and other circumstances. Special allocations should "give effect to the partners' desires, even if that means allowing the tax chips to fall where they may." 216 In many circumstances, it will be economically advantageous to make special allocations and meet the regulatory requirements. However, traps lie for unwary partners who neglect to consider the broader picture. For example, other tax consequences, such as those pursuant to I.R.C. sections 61, 83, 751, and 2051, may arise from section 704 allocations. 217 In addition, a partner may not be allowed an otherwise respected loss or deduction if he or she "lacks the requisite motive for economic gain." 218 Practitioners should therefore not be quick to suggest section 704(b) allocations. Both the objectives of the partnership and ancillary tax consequences should be examined thoroughly before deciding what, if any, special allocations might be appropriate.

H. Substantial economic effect

To have substantial economic effect, the regulations require that the allocation "be consistent with the underlying economic arrangement of the partners"; that is, the partner receiving an allocation must also receive the economic benefit or burden corresponding to that allocation. 219 Additionally, an allocation must be substantial. 220

1. Economic effect

A special allocation will have economic effect if the partnership agreement 1) establishes and provides for the maintenance of a capital account for each partner, 2) requires that liquidating distributions "be made in accordance with the positive capital account balances," and 3)

215. I.R.C. § 704(b)(1994). In other words, if an allocation does not have substantial economic effect, the IRS will not change the partnership agreement, but it will tax pursuant to the economic arrangement set forth in the agreement.

216. See Michael G. Frankel, Mini-Program: Workshop on Drafting Sophisticated Partnership Agreements, ABA TAX SECTION, February 3, 1991, at 510 (internal quotation marks omitted).


218. Treas. Reg. § 1.704-1(b)(1)(iii) (1994) (citing Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966)). The regulations also warn that if either section 465 or section 704(d) of the Internal Revenue Code apply, the loss or deduction allocation may be disallowed for the current taxable year. Id.


220. Id. § 1.704-1(b)(2)(f).
compels any partner having a negative capital account balance to restore the account out-of-pocket during the taxable year in which the partner's interest is liquidated. The following discussion addresses issues associated with each requirement, as well as an alternative to the third requirement—a Qualified Income Offset provision.

**Maintenance of capital accounts.** A capital account represents a partner’s equity interest in the partnership. The account is increased by a partner’s contributions to the partnership and partnership income and gain allocated to the partner pursuant to the partnership agreement. It is decreased by the value of partnership distributions received by the partner, the partner’s allocation of partnership expenditures, and the partner’s allocation of partnership losses and deductions.

**Liquidating distributions.** When a partner ultimately receives a liquidating distribution (upon the termination of the partnership or the complete termination of a partner’s interest in the partnership), the value of the distribution is limited by the positive balance of the partner’s capital account.

**Deficit restoration of negative capital accounts.** The partnership agreement must also require that a partner whose capital account has a negative accounting balance at the time of dissolution replenish the account to eliminate the deficit. This provision, however, is problematic for limited partnerships since limited partners are generally not held personally liable for the debts of the limited partnership.

To accommodate such situations and for ease of capital account maintenance, the regulations provide an alternative.

**Alternative to the out-of-pocket restoration requirement: Qualified Income Offset.** A Qualified Income Offset provision ensures that an inadvertent negative capital account will be restored as soon as possible by requiring the partnership to allocate future income to the deficit capital account. Because limited partners cannot be compelled to contribute additional capital to the limited partnership (since their risk is limited to

221. See id. § 1.704-1(b)(2)(ii)(b).
224. Id.
226. Whether the account ever becomes negative is not the issue. The partnership agreement must provide for the restoration of a deficit capital account. Note that with the deficit make-up provision (as opposed to a Qualified Income Offset), it is unimportant how allocations are made (assuming they meet the substantiality requirement), since if a partner receives more tax-favorable allocations than other partners and his capital account becomes negative, that partner will eventually make it up out-of-pocket. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (1994).
227. This notion applies to members of a limited liability company (LLC) as well.
their investment), limited partnerships must employ this provision in lieu of an out-of-pocket restoration provision. However, the Qualified Income Offset is only effective as to unanticipated distributions resulting in negative capital account balances. If the partners intentionally cause an account balance to become negative, any special allocation made by the partnership will not have economic effect.

2. **Substantiality**

An allocation will be substantial if 1) it will likely "affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences," 2) it does not reduce the overall tax burden of the partners below that which would have applied had the partners not made the allocation, and 3) it has significant impact upon the economic relationship of the partners with reference to what would have occurred had they not made the allocation. However, if the allocation is transitory (i.e., an offsetting allocation will occur in a year subsequent to the original allocation), absent a strong likelihood that the offsetting allocation will occur more than five years after the original allocation, the original allocation will not be substantial.

3. **Economic effect equivalence**

If an allocation fails the substantial economic effect test, it may yet be deemed to have economic effect if the partners can demonstrate that the same economic results would have occurred had allocation satisfied the substantial economic effect test, independent of the partnership's economic performance.

Thus, special allocations are those allocations that depart from an equal (or proportionate) allotment of partnership income, gain, loss, expenses, depreciation, and other items to the various partners. To be respected by the IRS, special allocations must have substantial economic effect or otherwise meet the economic effect equivalence provision of the

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228. In the case of nonrecourse debt, since the lender bears the risk, allocations attributable to the debt cannot have economic effect and must be allocated based on the partner's economic interests in the partnership. An exception is available to give economic effect to nonrecourse debt allocations if valid capital accounts are maintained, distributions upon liquidation are made in accordance with positive account balances, all other allocations have economic effect, and income attributable to nonrecourse deductions is allocated pursuant to minimum gain chargeback requirements. See Treas. Reg. § 1.704-2(c)-(g) (1994).


230. If, however, there is a strong likelihood that the offsetting allocation will occur more than five years after the original allocation is made, then the original allocation will be deemed to have substantial economic effect.

regulations. If partners neglect to ensure that one of these tests is met, they risk having the IRS reallocate the items according to the partners' actual economic interests in the partnership agreement. However, practitioners should be sensitive to situations in which partners would prefer to fail the tests in spite of the tax consequences, depending on the partners' broad economic and personal objectives.

I. Should the partnership consider employee benefits planning at the outset and, if so, what types of plans are tax favorable?

Employee benefit plans provide retirement savings and other benefits to partners and employees. For small start-up partnerships, an employee benefit plan may be premature from a cost standpoint. However, Congress has provided a variety of tax-favorable plans that may serve the needs of a partnership in the future and a few plans that can serve a partnership with a modest projected budget.

1. Favorable tax treatment of retirement plans

The tax provisions governing retirement benefit plans were in large part enacted under the Employee Retirement Income Security Act of 1974 ("ERISA"). In general, if a particular plan qualifies for tax-favored treatment under ERISA, neither the partnership ("employer") nor the partner or employee ("participant" in the plan) is taxed on the contributions or appreciation of those contributions within the plan. Instead, if the plan is properly created and administered, the participant is taxed only as he or she receives the benefits upon retirement or other distribution event.

To avoid taxation of plan contributions, the plan must be either a "qualified plan" or a plan to which Congress has nevertheless granted favorable tax treatment.

a. Qualified plans

Qualified plans take two forms: defined benefit and defined contribution plans.

Defined benefit plans. A defined benefit plan designates a certain amount of money to be distributed (usually in monthly installments) to

234. Id. § 402(a)(1).
235. Although the Internal Revenue Code does not use the term "qualified plan," it is generally understood to mean "an employer-sponsored pension, profit-sharing, or stock bonus plan" pursuant to section 401(a) of the Internal Revenue Code or an annuity plan under section 404(a)(2). JOHN H. LANGBEIN AND BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW (1990).
the participant upon retirement, or to a contingent beneficiary, such as a spouse, upon the participant’s death. Its maintenance requires, among other things, the creation of a lump trust account and a contractual obligation on the part of the employer to keep the fund actuarially sound, based on a contribution formula. Defined benefit plans are used primarily in large corporations, partnerships, and government.

**Defined contribution plans.** A defined contribution plan defines the value of the contribution that the employer must contribute to the plan. The contribution amount is usually based on the participant’s compensation and is allocated to an individual account for the participant. Withdrawal takes place upon a distribution event, such as retirement or disability. When such an event occurs, the participant receives the balance of his or her account. A variety of defined contribution plans exist and can cater to partnerships.

**b. Other plans**

Congress has recognized some other plans as deserving of favorable tax treatment. Perhaps the most notable is the individual retirement account (“IRA”). An IRA can be created by any individual, who may contribute up to $2000 of his or her annual earnings to the account tax-free. Withdrawal restrictions are similar to those of qualified plans, and rollover contributions are permitted with certain limitations.

Building on the IRA, the small start-up partnership might consider a simplified employee pension (“SEP”) under section 408(k) of the I.R.C. Conceptually, a SEP is an IRA financed by the partnership, except that the partnership may contribute larger sums than an individual could under section 408(a). Partnership contributions are deductible and only upon

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238. *Id.* at 919. The soundness of the funds cannot be contingent on the employer’s profitability.
239. *Id.* at 919. The type of formulas that can be employed are either based on a unit benefit or a flat benefit. LANGBEIN & WOLK, supra note 235, at 42.
240. *See* Scott, supra note 237, at 919.
241. *Id.*
242. *Id.*
243. *Id.*
244. *Id.* at 919. Examples of defined contribution plans include money purchase plans, target benefit plans, profit sharing plans, stock bonus plans, employee stock ownership plans (ESOPs), a qualified cash or deferred arrangement (CODA), and Keogh Plans. Although an individual retirement plan resembles a defined contribution plan, it is not a qualified plan under section 401 of the Internal Revenue Code. Nevertheless, it receives tax-favorable treatment under section 408.
246. *Id.* § 408(d).
247. *Id.* § 408(d)(3).
248. *Id.* §§ 408(j), 415(c)(1)(A).
distribution are the funds taxable to the employee. As with qualified plans, however, a SEP cannot discriminate in favor of highly compensated employees or partners.

The true grace of the SEP is its simplicity. It offers a short-term, quick solution to providing an employee benefit plan in which employees and partners alike can participate. It is inexpensive and requires only a modicum of administrative attention compared to that required of qualified plans. Further, the preparation of required reporting documents is performed by the bank servicing the SEP accounts.

c. Requirements and restrictions

Aside from the benefits of these plans, Congress has imposed strict requirements as to, among other things, vesting, forfeiture, minimum coverage, nondiscrimination, commencement of benefits, and fiduciary duties. Disqualification and employer misconduct can result in severe tax consequences, penalties, as well as litigation. The more complex the plan, the easier it is to be disqualified inadvertently. When choosing a plan, the partners should consult a pension planning specialist to help ensure that all proper steps are taken so that the plan becomes a benefit to the partnership and not a compliance nightmare.

2. Other benefits

Other benefits for employees include employer-provided health care, lodging, and group term life insurance. Unfortunately, these benefits are not available to partners. After consulting the projected budget, the practitioner should discuss with the client which benefits will be provided.

249. Id. § 408(d)-(e). Salary reduction arrangements are also available to a partnership with twenty-five or fewer employees. Such arrangements allow an employee to make tax-deductible contributions to his or her SEP (typically called a "SARSEP"). See id. § 401(k)(6).

250. See id. § 401(k)(3).

251. For example, qualified plans require that a "summary plan description" be drafted and given to participants before the plan is effective. See 29 U.S.C. § 1021(a)-(b) (1994). Under section 408 of the Internal Revenue Code, no such document is required.

252. The disadvantages associated with a SEP include its short-term nature, limited number of benefits, and exposure to an early distribution tax, which the partnership cannot control.


254. See id. § 1053(a), (d)-(e).

255. See id. §§ 1051-1052, 1081.


258. See id. §§ 1101-1114.

259. See id. §§ 1131-1145.

260. See generally RIA United States Tax Reporter 13,509.01; Choice of Entity, Tax Mgmt. (BNA) No. 700 (comparing legal and tax differences between partnerships, S corporations and C corporations).
IV. Major Modifications of General and Limited Partnerships

A. How will the partnership deal with dissolution and continuation?

1. Dissolving the Partnership

As defined by the UPA, "dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up, of business." 261 This definition has been criticized as vague and lacking coordination between dissolution and nondissolution events. 262 The proposed American Bar Association ("ABA") amendments to the UPA would delete the definition and simply state the causes of dissolution, whether mandatory, elected by the partnership, or by court decree. 263

"Dissolution" is not defined in the URULPA. Thus, the UPA definition applies, raising the same problems and questions as are raised regarding the dissolution of general partnerships.

2. Dissolution Events

a. General Partnerships

One of the weaknesses of partnerships is that they do not have continuity of life. 264 Various events remove or threaten to remove a partnership from an active business stage to a stage of automatic dissolution, voluntary dissolution, or continuation. Some of these events have, by law, prescribed effects upon the partnership. Other events have default effects but are subject to alteration by the partnership agreement. The partnership should clearly define what constitutes an event of default so that it is unambiguous which party might be responsible for causing a dissolution in contravention of the agreement.

Unless argued otherwise, the partners may at any time dissolve or consent to dissolve the partnership without the happening of any specific event. 265 However, the happening of "any event which makes it unlawful for the business of the partnership to be carried on," 266 "the death of any

262. Harry J. Haynsworth et al., UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, Should the Uniform Partnership Act Be Revised, 43 BUS. LAW., Nov. 1987, at 161 (comparing UTAH CODE ANN. § 48-1-29 (1994) to UTAH CODE ANN. § 48-1-30 (1994)).
263. Haynsworth, supra note 262, at 161.
266. Id. § 48-1-28(3).
partner,"267 "bankruptcy of any partner,"268 or a "deed of court"269 will automatically dissolve a partnership. A court may, "[o]n application by or for a partner," decree a dissolution based upon a partner's lunacy, inability to perform contractual duties, conduct prejudicial against the partnership, or willful or persistent breach of the partnership agreement.270 All of these dissolution events are automatic under the Utah and Uniform Partnership Agreements.

Other events force the question of dissolution, but are currently at the discretion of the partners as to whether they will act to dissolve the partnership. Partners must decide whether retirement, incapacity (mental or physical), other voluntary withdrawal, wrongful withdrawal, or the admission of a new partner will legally dissolve the partnership.271 According to the UPA Subcommittee, death and bankruptcy should be removed from the automatic dissolution category and placed among these discretionary events.272

A partnership may agree to prohibit the above actions and expressly make them dissolution events. In such a case, any partner may dissolve the partnership, either voluntarily or involuntarily, but in so doing would be said to dissolve the partnership "in contravention of the agreement."273 Although the acting partner would incur liability for resulting damages,274 the partnership would probably be unable to prevent dissolution, unless otherwise agreed.275

Regarding the discretionary dissolution events, the partners may originally agree to maintain the power to expel partners for acting wrongfully, expressly making such "wrongful actions" nondissolution events. In this case the acting partner will again incur liability for the damages caused by that wrongful withdrawal,276 but the partnership would be empowered to continue the partnership without having to liquidate or wind up the business of the partnership.277

b. Limited Partnerships

Various events remove or threaten to remove a partnership from an active business stage to a stage of automatic dissolution, voluntary

269. Id. § 48-1-28(6).
270. Id. § 48-1-29(1).
271. UTAH CODE ANN. § 48-1-31 (some of these events are included as dissolution events).
272. Haynesworth, supra note 262, at 165, 166 (commenting on UTAH CODE ANN § 48-1-32).
273. UTAH CODE ANN. § 48-1-28(2).
274. Id. § 48-1-28(2).
275. Id. §§ 48-1-32(2)(a), -34.
276. Id. §§ 48-1-32(2)(a), -35(2).
277. Id. § 48-1-35(2)(b).
dissolution, or continuation. Some of these events have, according to the URULPA, prescribed effects upon the partnership. Other events have default effects but are subject to alteration by the partnership agreement.

A limited partnership is automatically dissolved “at the time specified in the certificate of limited partnership”\(^\text{278}\) or by judicial decree “ whenever it is not reasonably practicable to carry on business in conformity with the partnership agreement or for failure to comply with the requirements of [the Act].”\(^\text{279}\) Additionally, the withdrawal of a general partner may cause an automatic dissolution upon the limited partnership where there is no remaining general partner and no new general partner is admitted.\(^\text{280}\) No other events act to automatically dissolve a Utah limited partnership.

A limited partnership is dissolved by the happening of certain events which, at the discretion of the partnership, are “specified in writing in the partnership agreement,”\(^\text{281}\) or determined by the written consent of all partners.\(^\text{282}\)

3. Rights and Consequences of Dissolution

a. General Partners

Dissolution describes the legal, but not actual termination of a partnership, thus allowing the surviving partners minimal authority to continue to act on behalf of the partnership for winding up purposes.\(^\text{283}\) Upon dissolution, withdrawing partners are completely stripped of authority,\(^\text{284}\) and remaining partners are limited in their authority to “any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution.”\(^\text{285}\) Thus, a surviving partner may possess partnership property, but only for purposes of winding up. They may enter into new obligations necessary to complete existing contracts and they may employ lawyers and agents on behalf of the partnership. The surviving partners may also take necessary steps to protect partnership property.

The proposed UPA Subcommittee would additionally allow surviving partners the authority to conduct business for a reasonable time after dissolution, in order to preserve “partnership business or property as a going

\(^{278}\) Id. § 48-2a-801(1).

\(^{279}\) Id. § 48-2a-802. See also Crowther v. Carter, 767 P.2d 129, 133 (Utah Ct. App. 1989).

\(^{280}\) UTAH CODE ANN. § 48-2a-801(2) (1994).

\(^{281}\) Id. § 48-2a-801(2).

\(^{282}\) Id. § 48-2a-801(3).

\(^{283}\) Id. § 48-1-27 (“On dissolution a partnership is not terminated, but continues until the winding up of partnership affairs is completed.”).

\(^{284}\) Id. § 48-1-34 (stating that wrongfully dissolving partners do not have the right to continue in the winding up affairs of the partnership).

\(^{285}\) Id. § 48-1-32(1)(a).
concern," and deal with assets having no existing market. Each partner acting on behalf of the partnership in properly winding up the partnership's affairs, has a right to have partnership property applied to any liability arising from such winding up activities.

b. Limited Partners

The rights of partners in a limited partnership are roughly equivalent to the rights of partners in general partnerships. Upon the dissolution of a limited partnership, a wrongfully withdrawing general partner is liable for damages caused. All general partners who are not responsible for wrongful dissolution have minimal authority to wind up the affairs of the limited partnership. Alternatively, if the general partners are all liable for the wrongful dissolution, the limited partners are vested with rights to wind up the partnership.

4. Continuing the Partnership

a. General Partnerships

Utah partnerships, after dissolution, may continue rather than liquidate the partnership, if one or more partners so desire, provided the rights of the creditors and terminating partners are properly observed. Although such is only a legal dissolution and does not terminate the partnership, there still may be harmful effects. Legally, under the traditional aggregate theory of partnerships, if partnership relations change due to a partner's withdrawal or the admission of a new partner, a completely new aggregate of partners is created. Therefore, the aggregate may be subjected to the following: due on sale provisions; the conveyance of assets from the old partnership to the new partnership; obtaining new insurance policies under new partnership aggregate names; tax laws requiring the closing of pre-dissolution books and the beginning of the books on behalf of the continuing partnership. Such effects can be troublesome and expensive.

286. Haynsworth, supra note 262, at 168.
288. Id. § 48-2a-602.
289. Id. § 48-2a-803.
290. Id. § 48-2a-803
291. Id. §§ 48-1-38(2), (3), (5), -39. If the partnership is continued without settling with the terminating partner, under most circumstances that party may later choose between (1) the value of his interest at the time of the dissolution plus interest or (2) in lieu of interest, actual profits attributable to his share of partnership property. Id. § 48-1-39. For complications, see McKay v. Hardy, 896 P.2d 626 (Utah 1995).
292. Id. § 48-1-27.
293. Haynsworth, supra note 262, at 160.
294. Id. at 161.
More recently, in light of the entity theory of partnerships and the ABA recommended revisions to the UPA, a partnership is not an aggregate of individuals but a single group and the withdrawal or admission of a partner would be immaterial. Therefore, the remaining partners may continue the entity unaffected, for there is neither an actual nor legal dissolution. Utah partners may chose to agree in the partnership agreements to limit dissolution events and continue the partnership, if they wish to specify such a result among themselves.

b. Limited Partnerships

The general partners of a limited partnership may also choose to continue the business rather than proceed to wind up, liquidate, and terminate the partnership. Again, limited partnership law does not provide specifically for the actual effects of such a continuation, whether there is a legal dissolution or not. The principles and theories governing a general partnership are therefore analogous. However, it has been stated that limited partnership interests are more freely transferable than general partnership interests, and therefore may avoid a legal dissolution even more readily than would a general partnership.

5. Liability of Partners to Third Parties on Material Change of Partnership

a. General Partnership

Whether under the entity or aggregate theory, and whether a partnership is dissolved or continued, the withdrawal of a partner does not release the withdrawing or remaining partners from pre-dissolution debts. Only upon agreement of the requesting partner, the partnership creditor, and the remaining partner(s), is the partner released from existing liability, although "such an agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business." Moreover, in order to continue the partnership, the remaining partners must indemnify the withdrawing partner(s) against present and future liabilities.

b. Limited Partnerships

As stated above, the general partners of a limited partnership are generally governed by the law of general partnerships. On the other hand, the liability of withdrawing limited partners is not really an issue,

296. Johnson, supra note 264, at 8.
298. Id. § 48-1-33(2) (Supp. 1997).
299. Id. § 48-1-35(2)(b).
as limited partners are not liable to third parties for the partnership debts beyond their own contributions.  

B. How will a partner be allowed to liquidate the partnership interest?

Under the I.R.C., "liquidation of a partner's interest" means "the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." For many reasons, a partnership may decide to liquidate one of its partner's interest, and the partnership agreement should spell out when, how, and under what conditions this is to be accomplished or allowed. Some of the common reasons for liquidating a partner's interest are because a partner dies, becomes disabled, or becomes incompetent to carry out required duties toward the partnership. Partners should also consider up front how the partnership may proceed in liquidating a partner's interest without terminating the partnership. Of course, there are instances when a partner is encouraged to leave for valid reasons, such as retirement. A partnership may want to consider different methods of liquidation or valuation to appropriately address a variety of circumstances.

Liquidating a partner's partnership interest for any reason unavoidably causes a legal dissolution of the partnership. Expulsion of a partner for bona fide business reasons is permitted by the Utah Code and may be authorized by the partnership agreement. "Generally, no gain or loss will be recognized on distributions to partners in liquidation of a partnership, unless the cash received exceeds the partner's adjusted basis in his partnership interest."  

In addition, since the dissolution of a partnership does not of itself discharge any partner's liability, the partnership should also provide for ways to mitigate the partnership's liability incurred by the partner who is being expelled. The Utah Code provides that:

A partner is discharged for any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.

300. UTAH CODE ANN. § 48-2a-303 (1994).
303. Id. § 48-1-28(1)(d).
304. Alston R. Martin, Selection of Entities: C or S Corporation, LLC, or Partnership, C884 ALI-ABA 955, 1006-1007 (Feb. 10, 1994).
continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.  

In other words, if a partner incurs unauthorized liabilities prior to his expulsion, absent contrary partnership agreement provisions, the other partners will be liable. Therefore, a partnership may want to consider inserting special provisions that allow a partnership to be indemnified from an expelled partner, especially in the case where the partner is expelled for incurring unauthorized liabilities on the partnership. On the other hand, if liquidating a partner's interest is due to the retirement of that partner, it may be important to assure that the retiring partner's liability will be absorbed by the partnership. An assumption will achieve this purpose.  

1. Valuation Issues  

When liquidating a partner's partnership interest, the partnership is required to pay the leaving partner his or her rightful interests in the partnership. Even when partners are expelled for bona fide reasons, they are still entitled to their share of the partnership less the damages caused to the partnership. If the partner is deceased, unless otherwise agreed in the partnership agreement, the legal representative of the deceased partner will be entitled to receive the decedent's partnership interest. The method for valuation of partnership interests should be determined at the time the partnership is formed. To wait until partnership dissolution to formulate a method for determining partnership interests will likely create considerable controversy, since this can be an emotional time.  

The Utah Code sets forth the rule that will apply in setting accounts between partners, unless they have agreed otherwise:  

In settling accounts between the partners after dissolution the following rules shall be observed, subject to any agreement to the contrary:  

(1) The assets of the partnership are:  
(a) partnership property; and  
(b) contributions of the partners specified in Subsection (4).  

306. Id. § 48-1-33(2) (emphasis added).  
308. UTAH CODE ANN. § 48-1-35(2) (1994).  
309. Id. § 48-1-39.
(2) The liabilities of the partnership shall rank in order of payment, as follows:
   (a) those owing to creditors other than partners;
   (b) those owing to partners other than for capital and profits;
   (c) those owing to partners in respect of capital; and
   (d) those owing to partners in respect of profits.

(3) The assets shall be applied in the order of their declaration in Subsection (1) to the satisfaction of the liabilities.310

The scheme presented in this section may be altered by the partnership agreement, and partners should therefore decide up front if they would prefer a different order of distribution.

Perhaps one of the most common problems faced by a partnership is its treatment of goodwill upon liquidating a partner’s interest. Goodwill is defined in Utah as “a transient intangible something connected with a business. It is not corporeal property, but rather an asset without physical form, an element responsible for profits in the business.”311 Though important, goodwill is not generally treated as an asset with a recognizable monetary value unless otherwise agreed by the partners.312 Therefore, it is important that if goodwill is an essential component to the partnership, the partnership agreement should indicate if and how goodwill will be valued at liquidation. If a partner’s interest is liquidated due to that partner’s fault, a method should also be decided up front on how to decide whether goodwill has been damaged, and how to assess such damages. This is especially important for a service partnership where the partners contribute primarily their professional skills to the partnership. Though individual reputation is vital to the success of a service partnership, no goodwill value will be attached at liquidation unless it is stated explicitly in the partnership agreement.313

2. Tax Issues and Hot Assets

Although this article is not the place to summarize all of partnership taxation, a few tax principles are especially important in connection with decisions made at the outset of a partnership or in crafting a basic partnership agreement regarding the potential tax consequences of liquidating a partner’s interest in a partnership. For example, a partnership is a pass-

310. Id. § 48-1-37.
through entity. Therefore, a simple way to understand the tax issues involved when a partner’s interest is liquidated is to compare it to a marriage. When a partner separates from a partnership, it is as if a divorce occurs and the parties take their share of what belongs to them. In theory, there is no “sale or exchange,” which is why there is usually no tax liability accompanying such an event. The result will be different if the leaving partner takes cash. Although there is no tax liability immediately incurred upon liquidation, the basis of the property distributed to the partner may need adjustment. The I.R.C. states that “[t]he basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest shall be an amount equal to the adjusted basis of such partner’s interest in the partnership reduced by any money distributed in the same transaction.”

If more than one type of property is distributed, the partner needs to first allocate basis to any section 751(c) unrealized receivables and section 751(d)(2) inventory. (Section 751 assets are often referred to as “hot assets” and will be discussed further below.) The remaining basis will be allocated proportionally among the distributed properties. In the planning stage, a partnership may want to decide what property will first be distributed and whether cash will be distributed when liquidating a partner’s interest in the partnership.

Liquidating a deceased or retiring partner’s interest presents a different issue, which is controlled by section 736 of the I.R.C. Section 736 identifies two kinds of distribution: a distributive share or guaranteed payments, and payments for interest in partnership. These two types of distribution have different tax consequences to the partnership and the departing partner. Section 736(b) payments are generally received tax-free or as capital gain by the departing partner, but the distribution does not reduce the amount of partnership income taxable to the continuing partners. On the other hand, section 736(a) payments are treated as ordinary income to the partners and are deductible from the partnership’s taxable income and taxable to the leaving partner. Section 736(a) payments may be cash or property and includes unrealized receivables per section 736(b)(2)(A). However, section 736(b) payments cannot include unrealized receivables or good will unless otherwise agreed by the partners per section 736(b)(2)(B). Therefore, if a partnership wants to use unrealized receivables and goodwill in liquidation as section 736(a) payments, it should provide for it. Further, due to the different tax consequences to the partnership and the departing partners generated by sec-

315. Id. § 732(c)(1).
316. Id. § 732(c)(2).
317. Id. § 731(a).
tions 736(a) and (b) payments, the partners should plan which one will be used or if a combination of the two may be used at liquidation.

Section 751 assets (hot assets) may generate immediate ordinary income tax consequences to the selling partner. Section 751(a) of the I.R.C. states:

The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership which have appreciated substantially in value, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

As a general matter, any gain or loss recognized by a partner whose interest is liquidated or sold is characterized as capital gain or capital loss. Section 751 is an exception to this rule designed to ensure that the departing partner reports the ordinary income inherent in his or her share of certain partnership assets, which are unrealized receivables and substantially appreciated property. Unrealized receivables are defined as "goods delivered, or to be delivered ... and services rendered, or to be rendered." And "inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property." Therefore, partners may want to decide up front whether and to what extent hot assets can be used upon liquidating a partner's interest.

C. Will partners be allowed to transfer their interests?

General partnership interests are generally not freely transferrable. Although a general partner can transfer his or her interests in the profits of the partnership, he or she cannot transfer his or her interests in the management, unless previously agreed upon or unless unanimous consent is given. General partners must therefore decide how transferrable partnership interests will take place—whether transferrable upon consent or transferrable upon consent not unreasonably withheld.

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318. Id. §§ 731(a), 741.
319. Id. § 751(c).
320. Id. § 751 (d)(1)(A).
321. Tax Mgmt. (BNA) No. 700 at A-25 (June 12, 1995). See also Johnson, supra note 264, at 3.
323. Tax Mgmt. (BNA) No. 700 at A-25 (June 12, 1995) (as to the latter, "it is possible that an implied duty of reasonableness would be found to exist under state law").
Limited partnership interests are generally not freely transferrable. However, in Utah a limited or general partner of a limited partnership may transfer all or part of her profits interest unless such is restricted by the partnership agreement. An assignee of a limited partnership interest is admitted as a limited partner according to the partnership agreement. An assignee of a general partnership interest is admitted as a general partner only as permitted in the partnership agreement or by written consent of all partners.

D. How will the partnership deal with the admission of a new partner?

When an existing partner transfers his or her interest to a new partner, the new partner succeeds to the assigning partner’s capital account balance with no effect on the capital accounts of the other existing partners. When an existing partner assigns only partial interest to a new partner, the assigning partner and the new partner share pro-rata in the capital account, again with no effect on the capital accounts of the other existing partners.

Although the partnership agreement may allow for the admission of a new partner without causing the dissolution of the existing partnership, the admission of a new partner does raise other issues. Therefore, on creation of the partnership, partners must initially consider the effect of admitting a new partner, in general and specifically, on capital accounts and on the dilution of the rights of existing partners.

When a new partner contributes new capital in exchange for a partnership interest, the capital accounts of the pre-existing partners must be adjusted to avoid sharing previous appreciation or depreciation with the new partner. Failure to adjust would violate the substantial economic effect rule of section 704(b) of the I.R.C., which requires that each partner’s tax allocations must reflect the economic burdens and benefits borne by that partner.

The recommended method of insuring such economic effect is to revalue partnership property according to the fair market value at the time of the admission.
of admitting the new partner and adjust the existing partners' capital accounts to reflect the inside partners' distributive share of built-in gain and loss.\textsuperscript{333} This has the effect of avoiding inadvertent capital shifts or special allocations, without economic effect, to the partner being admitted.

Another method of insuring such economic effect is to provide in the partnership agreement that upon admission of a new partner, any difference in the fair market value and adjusted basis of partnership property will be allocated to the pre-existing partners at the time of sale of such property.\textsuperscript{334}

Moreover, because general partnerships are managed by the partners themselves and each partner has "equal rights in the management and conduct of the partnership business,"\textsuperscript{335} unless altered by the partnership agreement,\textsuperscript{336} the partners may wish to protect their voting or management rights from dilution or from falling into the hands of strangers upon admission of new members to the partnership. Partnerships can limit transferability as one method of maintaining management control. Partnerships can also arrange for the equivalent of corporate preemptive rights by providing for a right of first refusal before any new interests are sold.

E. How will the partnership deal with an inadvertent termination?

I.R.C. section 708 states that a partnership is considered terminated if 1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of the partners in the partnership, or 2) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.\textsuperscript{337} The section further provides that if a partnership merges with another partnership or is divided into two or more partnerships, the resulting partnership will be deemed a continuation of the previous partnership if the members of the previous partnership own more than 50\% of the resulting partnership.\textsuperscript{338}

The Treasury Regulations clarify section 708(b)(1)(B) considerably by stating that even a sale of over 50\% of partnership interest to another member of the partnership will trigger the termination clause, but "a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partner-

\textsuperscript{333} Id.
\textsuperscript{334} Tax Mgmt. (BNA) No. 712 at A-39 (May 16, 1994).
\textsuperscript{335} UTAH CODE ANN. § 48-1-15(5) (1994).
\textsuperscript{336} Id. § 48-1-15.
\textsuperscript{337} I.R.C. § 708(b)(1) (1994).
\textsuperscript{338} Id. § 708(2).
ship interest, is not a sale or exchange for purposes of this subparagraph," neither is a contribution of partnership interests.339

When a partnership is consciously terminated, the partners will receive their interests in the partnership. When a partnership is terminated inadvertently under section 708 and all of the partnership property – including both sections 736(a) and (b) property – is constructively distributed, untimely and unexpected tax consequences may occur. Distribution of hot assets will immediately trigger tax liabilities to the partners. Therefore, it is important for the partners to prevent their partnership from terminating inadvertently. Such a purpose may be achieved through the partnership agreement restricting transfer of partnership interests. Also, the partners should also spell out how major modifications of the partnership structure such as merger and division should be determined. Otherwise, section 708(2) may cause undesirable tax consequences to the partners of the deemed terminated partnership.

F. Will the partnership be allowed to amend the partnership agreement?

Section 48-1-15(8) of the Utah Code states: “Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.” Therefore, unless otherwise argued, a partnership agreement may not generally be expanded without unanimous consent. To clarify which decisions may be made by majority consent, a partnership agreement should define what constitutes “ordinary matters connected with the partnership business.” As explained above, the Utah Partnership Act mandates the consent of all partners for other modifications of the partnership agreement. A partnership should consider whether it should adopt this default position, and what level of consent is sufficient to change the partnership agreement. If consent of all partners is required, the partnership may want to devise a way to resolve any deadlocks when one partner is being stubborn or unreasonable, thus thwarting any proposed modification on the partnership agreement even when it is beneficial to the partnership.

Special rules apply to limited partnerships. Under URULPA, “a certificate of limited partnership is amended by filing a certificate of amendment with the division.”340 Unlike the general partnership in which all partners may participate in the decisions to amend the partnership agree-

V. Securities Issues

Securities laws protect the investing public by requiring the issuers of securities to register with the Securities and Exchange Commission. The registration statements provide disclosure to the public but are costly to the issuer. General and limited partnership interests may or may not be securities, and if they are they may or may not be exempt from registration.

Under the Securities Act of 1933 a security exists where there is 1) investment of money, 2) in common enterprise, 3) based upon expectation of profits to be derived solely from the efforts of individuals other than investors, and 4) with a promoter having the option of contributing only entrepreneurial or managerial efforts.

A. Will the partnership interest be considered a security?

1. General partnerships

General partnership interests are not generally considered to be securities because the partners usually have the power to exercise significant control over the partnership's affairs. The fact that the investments are structured as general partnerships is not determinative of their status as securities. Instead the economic realities of the transaction determine whether they are investment contracts and covered by the SEC regulations. In most cases, whether the partnership interest is deemed a security or not will turn on the issue of control—whether the investors had an expectation of profits produced from the efforts of others.

The presumption that a general partnership interest is not a security may be overcome if the investor can establish that 1) an agreement among the parties leaves so little power in the hands of the partner that the agreement in fact distributes power as would a limited partnership; or 2) the partner is so inexperienced and unknowledgeable in business af-

341. Id. § 48-2a-202(3).
343. Id.
344. The Securities Act of 1933 § 2(1) [hereinafter SA].
346. Id.
347. Koch v. Hankins, 928 F.2d 1471, 1475 (9th Cir. 1991).
348. Id. at 1476.
fairs that he is incapable of intelligently exercising his partnership powers; or 3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot exercise meaningful powers.  

2. **Limited liability partnerships**

Limited liability partnership interests are generally considered to be securities. However, whether a particular investment constitutes a security depends on the facts and circumstances of the case. The main focus of the examination should be the contract. If the partnership contract retains real power in the partners, then the investments are not securities.

Statutes and judicial decisions make it clear that a limited partnership interest in a publicly traded partnership is a security under the 1933 Act. To date, some publicly traded limited partnerships have been filed under the 1933 Act and others have not. Those publicly traded limited partnerships which have not filed under the 1933 Act have, however, filed proxy statements which contain substantially the same information as the 1933 Act.

3. **Federal exemptions**

"The Securities Act of 1933 and thereunder contain exemptions from registration requirements for offers on sales of securities where the issuer, the securities, or the transaction meets certain statutory requirements." One of the easiest ways to qualify under the exemption requirement of the Security Act is to qualify under Regulation D. Rule 504, under Regulation D, promulgated under the authority of the Security Act section 3(B), allows offering up to one million dollars by the issuer in any twelve month period. Under this rule there is no limit on the number of investors, and there are no investor qualifications. However, no general solicitation is permitted. Rule 505 allows offerings by the issuer of up to five million dollars in any twelve month period to an unlimited number of accredited investors and to no more than thirty-five non-

351. Id.
353. Id.
354. Id.
355. See Welch, supra note 342, at 231.
356. Id.
357. SA, supra note 344, Regulation D, Rule 504 (b)(2) (1994).
358. SA, supra note 344, Regulation D, Rule 502 (c) (1994).
accredited investors.\textsuperscript{359} No general solicitation is permitted under this rule.\textsuperscript{360}

In addition to the limited offering exemptions under Regulation D, the following exemptions may also apply:

a. Intra

The intrastate exemption is provided for any security that is part of an issue offered and sold only to persons residing within a single state. The issuer must be a person or corporation residing or incorporated in, and doing business within, that state.\textsuperscript{361} One offer to an out of state resident results in the loss of the exemption.

b. Private placement exemption

The Security Act section 4(2) exempts private placements from registration, but does not exempt them from the anti-fraud provisions; courts look to investor sophistication, and availability of information.\textsuperscript{362} Information can be provided through either access or disclosure. Access may come through insider status. The following factors are particularly important in evaluating the public character of an offering: 1) number of offerees, 2) relationship of the offeree to the issuer, 3) relationship of the offerees to each other, 4) number of units offered, 5) size of the offering, and 6) manner of offering.\textsuperscript{363}

c. Small offering exemption under Regulation A

Regulation A allows for what is known as a “mini registration” for offerings of not more than five million dollars. It is available to U.S. and Canadian issuers who meet all requirements in the regulation.\textsuperscript{364} The “mini registration” is less burdensome than regular registration.

4. State exemptions

The first recourse for securities under blue sky laws is exemptions for securities listed on an exchange.\textsuperscript{365} Typical exemptions are for securities registered under the Securities Act of 1933 and the Securities Act of 1934, section 12.\textsuperscript{366} Transactions by fiduciaries may be another exemption.\textsuperscript{367} There is also an isolated transaction exemption, which was part of the Uniform Securities Act, which may be an option.\textsuperscript{368} “The key point is

\textsuperscript{359} SA, supra note 344, Regulation D, Rule 505 (b)(2)(I) & (ii) (1994).

\textsuperscript{360} SA, supra note 344, Regulation D, Rule 502 (c) (1994).

\textsuperscript{361} See SA, supra note 344, § 3(a)(11) (1994).

\textsuperscript{362} Doran v. Petroleum Management Corp., 545 F.2d 893, 900 (5th Cir. 1977).

\textsuperscript{363} SEC v. Murphy, 626 F.2d 633, 645-648 (9th Cir. 1980).

\textsuperscript{364} See Welch, supra note 342, at 232, 233.

\textsuperscript{365} See supra note 349.

\textsuperscript{366} Id.

\textsuperscript{367} Id.

\textsuperscript{368} Id.
that no one is really certain how the isolated transaction exemption will operate in the context of a substantial trading market for limited partnership interests.\footnote{369}

Utah offers a limited offering exemption patterned after the Uniform Limited Offering Exemption in conjunction with Regulation D.\footnote{370} Partnerships should review these issues and requirements before issuing securities.

B. Will the partnership interest be traded publicly?

Section 7704(a) provides that a publicly traded partnership is treated as a corporation for federal tax purposes unless the partnership meets the 90 percent qualifying income test of section 7704(c), or qualifies as an existing partnership.\footnote{371} Under section 7704(c), if 90 percent of a publicly traded partnership’s income consists of passive income in the form of interest, dividends, rents, etc., the partnership will not be taxed as a corporation.\footnote{372} An existing partnership is a partnership that existed on December 17, 1987.\footnote{373} The exemption for existing partnerships will not be available after December 31, 1997.\footnote{374}

A partnership is publicly traded if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent thereof. With its adoption of regulation 1.7704-1 on December 4, 1995, the IRS adopted final regulations which provide guidance as to when securities will be treated as readily tradable on a secondary market or a substantial equivalent thereof.

1. Established securities market

Established securities markets are national securities exchanges, foreign securities exchanges, regional or local exchanges, and interdealer quotation systems.\footnote{375}

2. Secondary market or substantial equivalent thereof

Generally, partnership interests are traded on an established securities market or the substantial equivalent thereof if, taking into consideration all the facts and circumstances, the partners are readily able to buy, sell,
or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.\(^{376}\)

A secondary market or the substantial equivalent thereof may be found where: 1) partnership interests are regularly quoted by any person, such as a broker or dealer, making a market in the interests; 2) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to buy or sell transactions at the quoted prices for itself or on behalf of others; 3) the holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or 4) prospective buyers and sellers otherwise have the opportunity to buy, sell or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in 1-3.\(^{377}\)

3. **Involvement of the partnership required**

In order for partnership interests to be considered to be traded on an established securities market or substantial equivalent thereof, the partnership must: 1) participate in the establishment of the market or the inclusion of its interests thereon; or 2) recognize any transfers made on the market by redeeming the transferor partner or admitting the transferee as a partner or otherwise recognizing any rights of the transferee.\(^{378}\)

4. **Safe harbors**

Many safe harbors are provided to protect transactions from being treated as the trade of partnership interests on a secondary market or the substantial equivalent thereof. Some of the more notable safe harbors are: transfers at death, transfers between family members, transfers under a redemption or repurchase agreement, transfers through a qualified matching service, private placements, and lack of actual trading (i.e. when partnership interests transferred during the taxable year do not exceed two percent of the total partnership interests).\(^{379}\)

C. **Will there be a tax matters partner?**

The tax matters partner functions as a liaison between the partnership and the IRS, representing the partnership in all tax matters before the

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\(^{376}\) *Id.* § 1.7704-1(c)(1).

\(^{377}\) *Id.* §§ 1.7704-1(c)(2)(i)-1.7704-1(c)(2)(iv).

\(^{378}\) *Id.* §§ 1.7704-1(d)(1)-1.7704-1(d)(2).

\(^{379}\) *Id.* § 1.7704-1(e).
The partnership may designate the tax matters partner on the partnership tax return. If the partnership’s tax return does not contain a space for the designation of a tax matters partner, the partnership may designate the tax matters partner by attaching a statement to the partnership’s tax return. In the event the partnership does not designate a tax matters partner, the general partner having the largest profits interest will be deemed to be the tax matters partner by the IRS.

The tax matters partner’s duties include: representing the partnership in administrative proceedings, obtaining extensions for tax assessments for all partners, entering into a settlement agreement with the IRS which is binding on all partners, selecting the forum for litigation, and keeping the other partners informed of all proceedings relating to the partnership’s tax return.

If the tax matters partner fails to perform assigned duties or negligently performs, no relief will be provided to the other partners. In such a situation, the other partners may have a cause of action against the tax matters partner for breach of fiduciary duty.

D. How will the partnership make elections?

Elections affecting the computation of taxable income derived from a partnership must be made by the partnership. Elections to be made at the partnership level include: the method of accounting to be used in computing partnership income, the method for computing depreciation on partnership property, the expense of depreciable property, the amortization of business start-up costs, and the optional adjustment to basis of partnership property under 734 and 743 of the Internal Revenue Code.

In order to elect the optional adjustment to basis of partnership property under 734 and 743, the partnership must file a written statement of the election with the partnership’s tax return for the first tax year to which the election applies, as set forth in 1.754-1(b). The other elections must also be made by filing a written statement of the election with the partnership’s tax return.