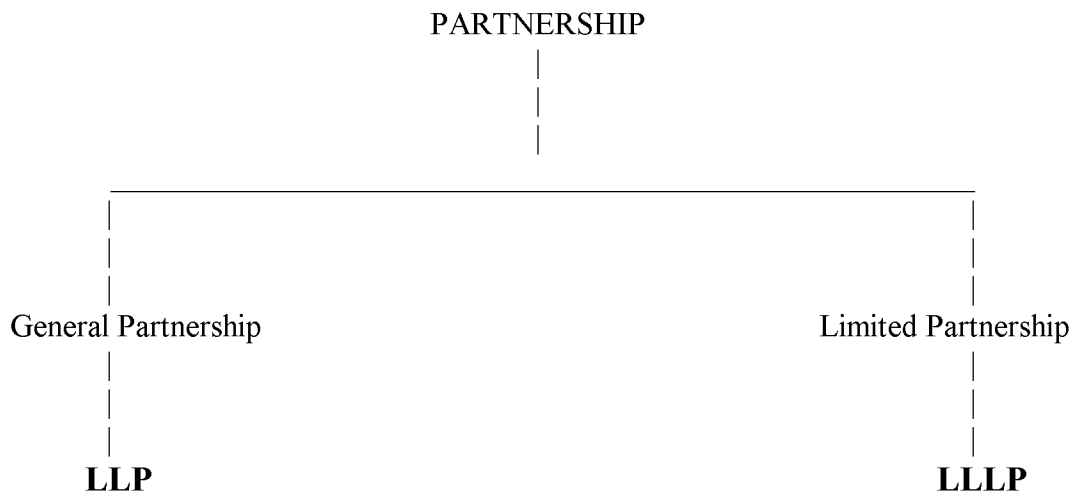


# CREATING LIMITED LIABILITY FOR A GENERAL PARTNERSHIP. . . LLP OR LLLP?

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Hatcher, Stubbs, Land Hollis & Rothschild,  
a Limited Liability Partnership

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The partnership is one of our oldest business entities. For many years it was the most basic, if not the only, entity choice that combined the efforts of more than one individual. For example, who could forget the partnership of Jacob Marley and Ebenezer Scrooge in Charles Dickens' Elizabethan England? As commerce progressed, though, other entities, such as the chartered corporation and later the corporation, gained favor. These choices offered limited liability as a main advantage because it enabled businessmen to pursue more ventures, which, in turn, created exponential-like business growth.

Gradually, as people (and their state governments) began to recognize the fact that limited liability was productive, the process of incorporating and gaining the limited liability advantage

became easier. In light of this, incorporators no longer have to seek a legislative act or a judicial decree to gain limited liability. This process has now been reduced to a simple public filing with the Secretary of State's office in recognition of the fact that the cornerstone of limited liability is notice to third parties.

Despite this growth, the extension of limited liability to general partnerships has been a fairly recent development. The Georgia Limited Liability Partnership Act, which provided for the creation of Limited Liability Partnerships ("LLPs"), became effective only as recently as July 1, 1995.<sup>i</sup> The amendments which allow for Limited Liability Limited Partnerships ("LLLPs") are even more recent.<sup>ii</sup>

As with any new law, refinements have been made and will continue to be made as various situations shine light on confusing or complicated provisions.

This article's purpose is to address one such confusing area -- the conversion of a general partnership to an LLP or an LLLP. While creating a new partnership with limited liability for its partners is a simple process, creating limited liability for an existing partnership can be more complicated. However, a full understanding of the fundamentals of the partnership entities is a prerequisite to fully comprehending the issues such a conversion raises. Accordingly, this article will first examine the entities of the partnership, the general partnership, and the limited partnership. It will then address the possible routes to take in the conversion from a general partnership to an LLP or LLLP. Finally, it will focus on which is the better choice for a particular situation.

## **I. The Partnership Genre**

The genre of the partnership is divided into two types. The first type is the older partnership entity, the "general partnership," while the second is the "limited partnership." In a general partnership, the only type of partner is a "general" partner. In addition, there is no limitation on the

liability of any of the partners, and each has the authority to bind the partnership and transact business on behalf of the partnership. This is the oldest form of partnership, and, as such, the term “partnership” is often used ambiguously to refer to it as well as the overall genre of partnership entities.

The second type of partnership is the “limited partnership.” In a limited partnership, there are both general and limited partners. The general partners in a limited partnership manage the partnership, and as a result of this privilege, they are the ones on whom the burden of liability falls. In contrast, the limited partners have limited liability as they can only lose the amount of their investments.<sup>iii</sup> In addition, as a cost of this limited liability, limited partners are limited both in their authority to act on behalf of the partnership and in their ability to participate in management decisions.

## **II. Partnerships: The Practical Steps of Creation**

The creation of the entity known as a “general partnership” is a relatively simple process. The partnership may come into being upon the filing of a statement of partnership in the office of the Clerk of Superior Court of any county.<sup>iv</sup> If a statement of partnership is filed, it must state: (1) the name of the partnership; (2) the location of the principal place of business; (3) the names and addresses of all the partners; (4) the term of the partnership, and such other information as expressly required by Official Code of Georgia Annotated (“O.C.G.A.”) §14-8-10.1.<sup>v</sup>

In contrast, to initially create a new entity as a “limited partnership,” the entity, at its inception, must file a certificate of limited partnership with the Secretary of State pursuant to O.C.G.A. §14-9-201.<sup>vi</sup> The certificate must set forth certain information and must be accompanied by the filing fee as set forth in O.C.G.A. §14-9-1101.<sup>vii</sup> Pursuant to O.C.G.A. §14-9-206.2, an existing

general partnership may elect to become a limited partnership by filing an election with the Secretary of State setting forth the information which that Code section requires.<sup>viii</sup>

### **III. LLPs and LLLPs: Additional Limited Liability Vehicles**

In addition to using the traditional limited partnership as a vehicle for limited liability for partners, Georgia law now provides a means to obtain limited liability for all partners in both the general partnership and in the limited partnership entities. A general partnership accomplishes this by forming a Limited Liability Partnership (“LLP”), while a limited partnership would form a Limited Liability Limited Partnership (“LLLp”).

Both an LLP and an LLLP are creatures of their respective parents, the general partnership and the limited partnership, though with certain modifications. The primary distinction between the two is that an LLP descends from a general partnership while an LLLP descends from a limited partnership. Otherwise, there is *no* substantial difference between the two entities, at least in terms of liability. Each provides limited liability for all of its partners, be they general or limited.

This is an important concept that is easily overlooked due to the confusing similarities in the nomenclature of the entities. One may find it helpful to take a moment and actually walk through the names of each because, despite their complexity, they are quite instructive and illustrative. First, an LLP is actually a limited-liability partnership. Remember that the term “partnership” is used ambiguously to refer both to the entity family of partnerships and as a reference to the “general partnership” subset of that entity family. (One could academically refer to the LLP as an LLGP, or a limited-liability general partnership.) The LLP is a general partnership in which (1) all the partners are general partners, and (2) they all have limited liability.

Using this same approach, the LLLP is a limited-liability, limited partnership. It is a limited partnership in which all the partners, be they general or limited, have limited liability. One differentiates an LLLP from an LLP in just this way.<sup>ix</sup> It has both general and limited partners. Considering the fact that an LLLP provides the limited liability to all the partners, the primary remaining distinction between the general partners and limited partners is that the general partners have the managerial capacity to control the partnership while limited partners do not.

#### **IV. General Partnership: Conversion to an LLP or an LLLP**

With an understanding of these entities now in hand, it becomes clear that an existing general partnership has two options when seeking limited liability. It can become either an LLP or an LLLP.

##### **A. Conversion of a General Partnership to an LLP**

If the general partnership seeks to become an LLP, O.C.G.A. §14-8-62 states that the partnership needs only to record a limited liability partnership election in the Superior Court Clerk's office.<sup>x</sup> As for tax consequences of this choice, there should generally be none upon the conversion of a general partnership to an LLP. Please note, though, that this is assuming that the partners' share of profits and losses and capital remain the same. If there is a change in the percentage share of profits, losses or capital, the usual partnership rules under the Internal Revenue Code would apply to determine if there is any gain.<sup>xi</sup> This same rule should hold true for the analogous conversion of a limited partnership into an LLLP.

##### **B. Conversion of General Partnership to an LLLP**

On the other hand, a general partnership may wish to convert to an LLLP. In analyzing such a conversion, one needs to remember that an LLLP is the derivative of a limited partnership. Thus, although all the partners have the desired limited liability, there remains a distinction between limited

and general partners in an LLLP. This distinction is that the general partners still have managerial authority, while the limited partners do not. As a result, the conversion should be a two-step process in which the general partnership first converts to a limited partnership and that limited partnership then converts to an LLLP.

A general partnership may become a “limited partnership” by adding limited partners or by giving its general partners limited partnership interests, in addition to their general partnership interests. Either of these is easily accomplished by amending the partnership agreement and filing the appropriate elections to become a limited partnership.<sup>xii</sup> After this first step of converting to a limited partnership, the new “limited partnership” can file an election to convert from a limited partnership to an LLLP under O.C.G.A. §14-8-62(g).<sup>xiii</sup>

One could argue that this second step could be left out, with the general partnership filing only one filing and one amendment to transform the general partnership directly to an LLLP. This argument arises from the fact that since one can form a new partnership as an LLLP without having to first form as a limited partnership,<sup>xiv</sup> one should be able to convert from a general partnership directly to an LLLP just as easily as one could convert to a limited partnership. Despite the possible validity of this argument, the safe route (at least until the state legislature can clarify the process) is to make the additional step, especially since this will leave a paper trail clearly showing the transformation of the general partnership to an LLLP.

The conversion of a general partnership to an LLLP should not have tax consequences if structured properly. In order to insure such an avoidance of tax consequences, the conversion must not alter any partner’s share of profits, losses, or capital.<sup>xv</sup> For example, if a general partnership with four equal general partners (25% each) desires to become an LLLP, each general partner could be

given a limited partnership interest. More specifically, each partner could be given a 1% general interest and a 24% limited interest. Each partner would then still have the same percentage interest in the partnership and would still receive distributions in the same amount as if no change had been made. The only difference would be that such distributions would be allocated to the respective limited and general partnership interests of each partner, rather than solely to her general interest.

Furthermore, a conversion could also be made in which only one partner would retain the sole 1% general partnership interest. As with the previous example, this would be a tax-free transaction because, for tax purposes, the primary consideration in such a conversion is whether the percentage interests in the partnership's profits and losses remain the same. Thus, it would not matter whether these percentages are in general or limited partnership interests.<sup>xvi</sup> For example, again assume a general partnership with four equal general partners desires to become an LLLP. However, only one partner would be the general partner, with a 1% general partnership interest and a 24% limited partnership interest. The three remaining partners would each be 25% limited partners.<sup>xvii</sup> This conversion should generally result in no tax consequences.<sup>xviii</sup>

However, one might argue the application of a control premium when a partner becomes the holder of the sole 1% general partnership interest. The argument would be that, even though the partner's percentage interest in the profits and losses remains the same, this would be a taxable event because the partner, as the only 1% general partner, now has complete control of the entity, where before he had only 25% control of the entity. Fortunately, Rev. Rul. 84-52, 1984-1 C.B. 157 provides guidance on this issue, clearly stating that gain is recognized in such conversions only to the extent that a change in a partner's share of liabilities results in a deemed distribution in an amount greater than the partner's adjusted basis. As a result, as long as the conversion does not result in a

deemed distribution in an amount greater than the now-controlling partner's adjusted basis, the conversion should be a tax-free event.

### **V. LLP vs. LLLP: Which is the Better Choice?**

Now that the reader understands how to proceed with the conversion of a general partnership to an LLP or an LLLP, the issue becomes which is the better choice.

The first advantage of converting a general partnership to an LLP is that it is easier to do and has fewer possible consequences. The sole requirement is the filing of an election, which entitles partners to limited liability with respect to creditors.<sup>xix</sup> Further, there is no change that needs be made to the partnership agreement, and there is no change among the partners except that each now has limited liability.

In contrast, the conversion of a general partnership to an LLLP would be a fundamental alteration of the entity. The conversion not only changes liability rules, but potentially changes the relationship between the partners themselves. As a result, in addition to filing the appropriate elections, the partnership agreement itself must be changed. Furthermore, if in so doing, the partners' percentage share of gains and losses is altered, then gain may be recognized under the applicable partnership provisions.<sup>xx</sup>

The primary reasons why a general partnership would convert to an LLLP instead of an LLP is to admit new "limited" partners or to accomplish certain estate planning goals. If a general partnership is converted to an LLLP, then steps should be taken to avoid gain. These preventative steps include, among other possibilities, allocating limited partnership interests in proportion to general interests so as to not change the partners' share of gains and losses, or, pursuant to Rev. Rul. 84-52, 1984-1 C.B. 157, making certain that if percentage shares are changed, any deemed

distribution is in an amount less than the partner's adjusted basis. It should be noted that for estate planning purposes, an LLLP, in some instances, may also offer greater discounts than afforded by an LLP.<sup>xxi</sup> A detailed discussion on such discounts, however, is beyond the scope of this article.

## **VI. LLP or LLLP: The Initial Choice**

If one happens to be forming a new entity and is choosing between an LLP and an LLLP, there are several things to consider. If the objective is that all the partners are to have equal control, an LLP is the appropriate choice. However, there are particular instances where an LLLP may be the better choice. One such instance is the obvious situation in which there may be some limited partners. Other such instances may include, as stated above, estate planning considerations.<sup>xxii</sup> In short, the choice hinges on the relationship the partners seek to have among themselves.

## **VII. CONCLUSION**

As can be seen, the partnership entity has evolved over time, and continues to evolve to provide new opportunities to the entrepreneur. No longer is limited liability confined to corporations or only to the traditional limited partner. The new entities of LLP and LLLP can provide this limitation of liability to all partners, be they limited or general, with the added advantage of no corporate formalities.

Whether the LLP or the LLLP will be the appropriate choice for your client will depend on the facts and circumstances of each situation. Again, in terms of liability, there is no meaningful difference between an LLP and an LLLP. However, there are nuances between the two that need to be analyzed in order to choose the entity that best suits your client's needs and goals.

## ENDNOTES

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<sup>i</sup>See 1995 Georgia Laws 470, §11.

<sup>ii</sup>See 1996 Georgia Laws 787, §3.

<sup>iii</sup>It should be noted that throughout this article, the term “limited liability” will refer to the fact that liability is generally limited to the amount of the partners’ investment, be they general partners or limited partners.

<sup>iv</sup>See O.C.G.A. §14-8-10(a).

<sup>v</sup>See O.C.G.A. §14-8-10.1.

<sup>vi</sup>O.C.G.A. §14-9-201 provides that the certificate must set forth:

- (1) the name of the partnership;
- (2) the address of the registered office and the name and address of the agent for service of process;
- (3) the name and business address of each general partner; and
- (4) any other matters the general partners determine to include.

This section is for limited partnerships formed after July 1, 1988. For provisions relating to limited partnerships formed prior thereto, see O.C.G.A. §14-9A-20.

<sup>vii</sup>The fee currently is \$60.00. See O.C.G.A. §14-9-1101(1).

<sup>viii</sup>O.C.G.A. §14-9-206.2 requires, in addition to approval by the partners, that the following information be set forth in the election:

- (1) the name of the partnership, corporation, or LLC making the election;
- (2) that it elects to become a limited partnership;
- (3) the effective date and time of such election, if later than the time of filing;
- (4) that the election has been approved by the partners pursuant to O.C.G.A. §14-9-206.2(a);
- (5) that filed with the certificate of election is a certificate of limited partnership in proper form pursuant to O.C.G.A. §14-9-201; and (6) a statement that states the manner and basis for converting the interests of the partners in the general partnership into interests as members of the limited partnership formed pursuant to such election. This section became effective July 1, 1997.

<sup>ix</sup> As a practical matter, the authors recommend the use of verbal references to the entities as “2LPs” and “3LPs” or “Double LPs” and “Triple LPs” which are both easier for the speaker to say as well as for the listener to understand. The reader may find this terminology helpful as it is easy for even the most astute partnership expert to get tongue-tied with these terms.

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<sup>x</sup>Under O.C.G.A. §14-8-62(a), this election must include:

- (1) The name of the partnership, which must include the words “limited liability partnership” or “LLP” or an abbreviation thereof pursuant to O.C.G.A. §14-8-63.
- (2) The business, profession, or other activity in which the partnership engages.
- (3) That such partnership elects to be an LLP.
- (4) That the election has been duly authorized.
- (5) Any other matters the partnership determines to include therein.

<sup>xi</sup>If there were such a change, there would be a “deemed” distribution. To the extent the deemed distribution exceeded that partner’s basis, gain would be recognized. *See* Rev. Rul. 84-52, 1984-1 C.B. 157, for a more detailed analysis.

<sup>xii</sup> *See* O.C.G.A. §14-9-206.2

<sup>xiii</sup>This election is filed in the office of the Clerk of Superior Court and should be accompanied by a fee of \$60.00. The office of the Secretary of State, Corporations Division, indicates the LLLP election should also be filed with their office, though an additional \$60 fee is not required. This requirement is far from clear in the Georgia Code and should be legislatively corrected.

<sup>xiv</sup> *See* O.C.G.A. §14-9-206.2

<sup>xv</sup> *See* Rev. Rul. 84-52, 1984-1 C.B. 157.

<sup>xvi</sup> *Id.*

<sup>xvii</sup>Note, however, that in certain instances, this could bring into play the Passive Activity Loss rules. *See* IRC §469 (1998) and regulations thereunder. Generally, an interest in a limited partnership as a limited partner is inherently passive. The regulations provide some exceptions, such as where the partner also owns a general interest at all times during the year.

<sup>xviii</sup> *See* Rev. Rul. 84-52, 1984-1 C.B. 157.

<sup>xix</sup>O.C.G.A. §14-8-62.

<sup>xx</sup>*See* Rev. Rul. 84-52, 1984-1 C.B. 157. To the extent the alteration results in a deemed distribution in an amount greater than a partner’s adjusted basis, gain would be recognized.

<sup>xxi</sup>This is due in part to the argument that limited partnership interests could never be worth as much as general partnership interests because, by definition, limited partners do not have any management rights.

<sup>xxii</sup> One common estate planning scenario is where a family patriarch is given a small general partnership interest that manages the partnership plus a large limited partnership interest that he can

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gift away over the years. An even better variation of this estate planning situation is to set up a corporate general partner that would have perpetual life. Of course, the family patriarch's desire for control could still be met by his ownership of a majority of the general partner's corporate stock. It may be desirable to appoint the family patriarch as the managing partner and have the partnership agreement provide that the agreement cannot be amended until after his death. Thus, even if he has only a 1% interest at his death and has gifted the rest away, he still controls. All other general partnership interests should be subject to discounts for lack of control and marketability. With either option, though, the partnership is set up for an effective gifting plan and can be maneuvered into a position to take advantage of the appropriate discounts.