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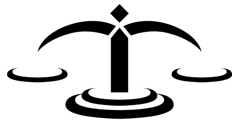

ILLINOIS STATE BAR ASSOCIATION

CORPORATION, SECURITIES & BUSINESS LAW FORUM

The newsletter of the ISBA's Section on Corporation, Securities & Business Law

The misunderstood limited liability partnership: A comparison to limited liability companies

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*By Kenneth J. Ashman and Bardia Fard**

Most practicing attorneys have at some point been presented with the following question: "I want to start a new business, what entity form should I select?" A typical answer to this question involves discussion of sole-proprietorships, general partnerships, limited partnerships, "C" and "S" corporations, and limited liability companies ("LLCs"). A well-reasoned answer, however, should also include discussion of the elusive limited liability partnership ("LLP"), an entity form with which many practitioners are not very familiar. Indeed, take an informal poll among your colleagues, and you will likely come to the realization that many practitioners have difficulty articulating the differences between LLPs and LLCs. This probably explains why there are approximately 119 times the number of domestic and foreign LLCs registered in Illinois over LLPs: 219,870 to 1,847.[2] Yet, in some circumstances, an LLP is probably better suited and more cost effective for your clients. This article provides a primer on certain similar and dissimilar features of LLPs and LLCs as organized under Illinois statute.[3]

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The History Behind LLPs and LLCs

The nation's first LLP legislation was proposed by Texas lawyers in 1991 in an effort to shield professionals, like lawyers and accountants, from being held vicariously liable for the misdeeds of their partners. By 1997, the year the LLP was sanctioned under the Uniform Partnership Act, over 40 states recognized the LLP form. Like other states, the Illinois LLP is nothing more than a general partnership that has filed a form with the Secretary of State to obtain certain liability protections. Accordingly, Illinois LLPs are created and governed, like general partnerships, under the Illinois Revised Uniform Partnership Act ("RUPA").[4]

Limited Liability Companies, on the other hand, significantly pre-date LLPs, as they were first introduced in 1977 by the Wyoming legislature. However, the adoption of LLC statutes among the remaining states was delayed by uncertainty as to how the IRS would classify LLCs for income tax purposes. States' reservations were quelled in 1988 when the IRS ruled publicly that LLCs could be treated as partnerships if they satisfied certain then-existing classification rules.[5] Since then, all states have adopted legislation authorizing LLCs. In Illinois, LLCs are created and governed under the Illinois Limited Liability Company of 1994 ("LLC Act"), which was significantly revised in 1998.[6]

Differences in Basic Characteristics?

Initially, there are differences in the terminology of LLPs and LLCs worth noting. Whereas an LLP is formed by filing a Statement of Qualification with the Secretary of State, an LLC is formed by filing Articles of Organization.[7] Further, co-venturers in an LLP are called "partners," while co-venturers in an LLC are called "members." The relationship between partners and the LLP are governed by a Partnership Agreement, and the relationship between members and the LLC are governed by an Operating Agreement. In the event that an LLP fails to provide a written Partnership Agreement, or an LLC failed to provide a written Operating Agreement, the default provisions of

Hardship distributions from 401(k) plans

By Markus May[1]

I was recently at a party talking with someone about helping people through difficult economic times. I mentioned advising a business client on when its employees can take distributions from a 401(k) plan for "hardship withdrawals." My friend thought this would make a great topic in today's economy and so this article was born.

In these trying economic times, when people are having difficulty making mortgage and other payments, people are looking for places where they can obtain cash to meet their obligations. Many people have a substantial amount of their net worth tied up in retirement accounts such as company profit sharing or 401(k) plans or various IRA type plans. This article will examine when employees are allowed to make hardship withdrawals from their existing 401(k) plans.

Generally, active employees under age 59½ can only take money out of their 401(k) plans by taking a loan from the plan or making a hardship withdrawal.[2] Assuming the employee has already maximized any loans allowed by the plan, the employee may be able to make a hardship withdrawal. The first thing to do is check the plan documents to make sure a hardship withdrawal is authorized under the plan.[3] A hardship withdrawal distribution is allowed only if it is made "on account of" the hardship.[4] To be made "on account of" the hardship, the distribution needs to be made due to an "immediate and heavy financial need" and be necessary to satisfy that need.[5] A financial need can qualify as being immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.[6]

IRS rules do not limit what qualifies as a hardship and this will be determined on a case-by-case basis.[7] The plan administrator decides whether something qualifies as a hardship by examining all the facts. Based on a telephone call with the IRS, the IRS currently does not look too much into what constitutes a hardship and will not second guess an administrator's decision. However, plan administrators may understandably be unsure of what constitutes an "immediate and heavy financial need." Thankfully, the IRS has created a "safe harbor" list of hardships which provides some guidance. Under the IRS safe harbor list, hardships deemed to be on account of an immediate and heavy financial need include those where payment is for:

1. Medical care expenses for the employee, the employee's spouse, or the employee's dependents. Note the definition of dependents is not limited to a person's children, but also extends to other dependents. The definition of dependent for medical expenses has been recently expanded to include a non-custodial child who is subject to a Code § 152(e) support test for a child of divorce parents. Non-prescription drugs or medicine are excluded from the definition of medical expenses according to the 2004 Regulations.[8]

2. Costs directly related to the purchase, excluding mortgage payments, of the employee's principal residence.[9]

3. The payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee or the employee's spouse, children, or dependents.[10]

4. Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage of that residence.[11] Interestingly, this provision does not include mortgage payments unless the mortgage payments are necessary to prevent the eviction of the employee from his or her home. Therefore, a hardship withdrawal cannot be made for a regular mortgage payment to prevent eviction proceedings. However, once eviction proceedings have begun, then a withdrawal can be made to prevent the eviction. This would presumably include all the past due mortgage payments plus other costs and can be used to prevent the eviction or foreclosure on the residence.

5. Payments for burial or funeral expenses for the employee's deceased parents, spouse, children, or dependents.[12]

6. Expenses for the repair of damage to the employee's principal residence that qualifies for a casualty deduction under § 165 of the Code.[13]

The distribution cannot exceed the amount necessary to satisfy the financial need.[14] However, the amount can include any taxes or penalties that need to be paid as a result of the distribution.[15] An additional limitation is that the maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution. Therefore, an employee cannot make a hardship withdrawal of any amounts attributable to employer contributions or earnings on the employee's contributions. There is an exception for some employer contributions that were grandfathered in by the Regulations.[16]

Employers are not limited to making only "safe harbor" distributions if the plan specifically provides for other events the employer considers a hardship. However, the determination of the existence of an immediate and heavy financial need and the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.[17] Employers could consider reviewing the hardship distribution rules in their current 401(k) plans to determine if distributions other than those falling within the "safe harbor" guidelines should be allowed. For example, an employer may wish to expand the hardship withdrawal to include payments related to an employee's bankruptcy.

Further, under § 826 of the Pension Protection Act of 2006 and Notice 2007-7 of that Act, a "primary beneficiary" under the plan is allowed to be treated the same as a spouse or dependent. This provision only applies to payment for medical care expenses, tuition, or burial or funeral expenses under numbers 1, 3 or 5 of the safe harbor provisions. In order for such hardship distributions to be made, the plan needs to allow hardship distributions to primary beneficiaries. The primary beneficiary is someone who has an unconditional right to all or part of the participant's account balance under the plan upon the participant's death. This provision could be useful if the participant wanted to help contribute to someone's college education and did not have other assets to help pay for the education.

In order to be treated as being necessary to satisfy an immediate and heavy financial need, all of the following requirements need to be satisfied:

1. The distribution is not in excess of the amount of the immediate and heavy financial need. The amount may include amounts necessary to pay federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution;[18]

2. The employee has obtained all distributions and nontaxable loans currently available under all the plans maintained by the employer; and[19]

3. The employee is prohibited under the terms of the plan from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least six months after receipt of the hardship distribution.[20]

If an employee has other assets available to satisfy the need, a hardship distribution is not allowed. This determination is to be made on the basis of all the relevant facts and circumstances.[21] Further, the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Therefore, a jointly owned vacation home would be considered a resource of the employee. However, property held under an irrevocable trust or under the Uniform Gifts to Minors Act is not treated as an employee resource.[22]

The employer is entitled to rely upon an employee's representation of the immediate and heavy financial need not being capable of being relieved from other resources unless the employer has actual knowledge to the contrary that the need cannot be relieved:

1. Through reimbursement or compensation by insurance or otherwise;

2. By liquidation of the employee's assets;

3. By cessation of the elective contributions or employee contributions under the plan;

4. By other currently available distributions and nontaxable loans under plans either by the current employer or any other employer; or

5. By borrowing from commercial sources on reasonable commercial terms.[23]

However, an employee is not required to take an action which would increase the amount of the need. For example, "the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing."[24]

Any distributions from a 401(k) will be includable in gross income for tax purposes and will, except in unusual circumstances, be subject to the additional 10 percent premature withdrawal penalty tax. Therefore, if an employee has another retirement account which may avoid the 10 percent penalty, the employee may wish to consider making a withdrawal from the other account rather than the 401(k) plan. For example, if an employee wishes to pay for education related expenses, using an IRA which can avoid the 10 percent penalty would be preferable to taking a 401(k) hardship withdrawal.

Conclusion

As can be seen from the above, obtaining a hardship distribution from a 401(k) plan is not a simple matter or an easy way to obtain money to pay for discretionary expenses. It really is a last resort to be used when an employee has no other financial means to address the need.

However, in those instances, a hardship distribution may be the one thing standing between an employee and homelessness or bankruptcy.

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[2] Aside from taking a loan, a hardship withdrawal, or death, disability or termination of employment, there are limited exceptions that allow a distribution from a 401(k) plan. Such exceptions include distributions for pre-2008 qualified reserve distributions and certain recovery assistance distributions related to hurricanes or storms. 26 C.F.R. § 72(t)(2)(G)(iii), 26 C.F.R. 1.401(k)-2(B)(i)(V), 26 C.F.R. 1400(Q), Farm Act § l5345, 26 C.F.R. § 1.401(k)-1(d)(1).

[3] 26 C.F.R. § 1.401(k)-1(d)(1)

[4] 26 C.F.R. § 1.401(k)-1(d)(3)

[5] Id.

[6] 26 C.F.R. 1.401(k)-1(d)(3)(iii)(A)

[7] Id.

[8] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(1)

[9] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(2)

[10] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(3)

[11] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(4)

[12] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(5)

[13] 26 C.F.R. § 1.401(k)-1(d)(3)(iii)(B)(6)

[14] 26 C.F.R. § 1.401(k)-1(d)(3)(iv)

[15] Id.

[16] 26 C.F.R. § 1.401(k)-1(d)(3)(ii)(B)

[17] 26 C.F.R. § 1.401(k)-1(d)(3)

[18] 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(A)

[19] 26 C.F.R. § 1.401(k)-1(d)(3) (iv)(E)(1)

[20] 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(2)

[21] 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(B)

[22] Id.

[23] 26 C.F.R. 1.401(k)-1(d)(3)(iv)(C)

[24] Id.