Module 1.3: Partnerships

Partnerships are one of the most flexible legal forms of business that can be created. Because of this, they can also be the most complex. In this module, we are going to discuss the various types of partnerships, along with their advantages and disadvantages. We are going to start with the definitions of a general partnership - which have no liability protections for it partners and then move on to the other forms of partnerships that do provide personal liability protections.

General Partnerships

General Partnerships are similar to the sole proprietorships we studied in the last module, in that by default they offer no personal liability protection. The *Uniform Partnership Act* defines a general partnership as "an association of two or more persons to carry on as co-owners a business for profit." This can be orally or in writing. There is no formal business entity such as a corporation, limited partnership, or LLC in existence. In this format, each partner is expected to contribute to the business in all aspects, i.e., labor, money, property, or skills. Each partner shares in the profits and losses of the business.

Although starting a general partnership is as easy as shaking hands and going to work, it is best to draw up a legal partnership agreement. I have seen some nasty fights when partnerships are dissolved. So, I see the partnership agreement like a marriage prenuptial agreement. It not only covers the distributions of income, allocations of income, deductions, expenses, and an explanation of how the business will operate, but it also states what will happen if the business closes, a partner dies or decides to leave the business and any restrictions on the sale a partnership interest.

To help you out, I've included a *sample partnership agreement* in the download section to the right of this video. If you would like a fill in the blank online process to create your partnership agreement, there are a lot of sites out there that will help you. One in particular creates one based on which state you live in. There is a link to this site in the section below this video and in the transcript. The URL for that is https://www.formslaw.com/partnership-agreement/

Although not *required* to file documents to create a partnership, like a corporation has to do, a partnership is treated as a separate legal entity - unlike a sole proprietorship. It can hold real and personal property, sue or be sued, or conduct business independently of its members. Each partner owns a partnership interest, but no partner owns a specific asset of the partnership. A *general* partnership does not have to file with most states, like corporations or limited partnerships do, but you should do some research (see our bonus section for the websites) or talk to a tax professional for your state to determine if an information return need to be filed.

Although a partnership is not a taxable entity, it determines how taxable items are passed through to the partners. It determines such things as the type and amount of income, gains or losses, deductions or credits. It decides accounting methods, depreciation methods and amortization costs - which we'll cover in Module 3.8. There may also be optional adjustments to the basis of partnership property - which we'll cover in Module 3.5.

Let's talk about liabilities.

Typically, each partner is also jointly and individually liable for the debts and liabilities of the business. This means that *any* of the partners is responsible for *all* of the debts. This is a concept that a lot of people don't realize when they start a partnership, but is vital knowledge to understand - in case that good friend you went into business with leaves you hanging with all the bills to pay.

This concept means that all the partners can *jointly* be held financial liable for the same act and also be held individually responsible for all restitution payments, even it they didn't participate in the original harmful act. Kind of like when the whole class has to miss recess when just one classmate broke the rules in elementary school. Or, imagine a whole group of restaurant staff being fired because one person stole money from the register.

So, if the partnership is sued and loses, the person suing you may collect the full value of the judgement from any of the partners. If that partner can't pay, then they may seek their money from the other partners. In other words, joint and individual liability tends to rise when it is difficult to pick a single person responsible for the injury, but it is easy to identify a closed group of persons (like a partnership), from which any of them is responsible for the injury.

There are also a few other types of legal liabilities. Some states practice proportionate or comparative liability, which prorates a percentage of the damages attributable to each defendant's conduct and assigns an amount.

Then there is market share liability, which deals with goods and multiple manufacturers. For example, most car manufacturers buy airbags from a subcontractor, so if a car's airbag malfunctions and someone is injured, both the card maker *and* the maker of the airbag may face liability.

As you can see, these laws were passed to protect the victims. This is one of the reasons the knowledge you will gain in this course is so important. You have to know at all times how your profit and loss situation is because what happens in a partnership affects your personal assets as well.

Easy to Create

Just like a sole proprietorship there are some advantages to a general partnership, such as being inexpensive to form, and giving the partners substantial flexibility with regard to making decisions and operating the business. Unfortunately, these advantages are heavily outweighed by the liability-related risks of a partnership, such as joint and individual liability, disagreements between partners, and sharing profits despite potentially unequal contributions.

But - you may have noticed that most of the doctor's organizations, law firms and many other large businesses are partnerships. That is because of the flexibility to structure them however they want.   That said, there *are* ways that partners can be protected by creating Limited Partnerships, Limited Liability Partnerships, or Limited Liability Companies. Most partnerships use these formats to shield themselves. We will talk about Limited Partnerships and Limited Liability Partnerships in this module and Limited Liability Companies in the Module 1.4.

I also want to note that individual states have many laws that govern exactly how partnerships operate, especially in the absence of a partnership agreement between the partner/owners. Nor do all states offer Limited Liability Partnerships.

So, let's review the pros and cons of general partnerships before we move on:

The Pros:

- Relatively easy to start, state fees (if any) are relatively low.
- No limit on the number or type of partners.
- Can be used to hold investments in other businesses and consolidate multiple lines of business.
- Flexible allocation of profit, loss, and distributions.
- Pass-through entities, so the partnership will not pay tax.
- Favorable tax treatment when liquidated.
- No double taxation of profits like C corporations.

The Cons:

- Requires a separate tax return.
- Unlimited liability for all partners (unless an LLC).
- Difficult to dissolve or change ownership without substantial planning.
- Requires tracking of basis for partners, both inside and outside the partnership (Module 2)
- Partners pay tax on the income when earned, not when it's distributed to them.
- Individual partner's share of income is subject to self-employment taxes.

- Cannot be sold whole. Assets, Licenses, etc must be transferred individually.

Limited Partnerships

There may be times when someone wants to just invest in your partnership (much like buying stock in a corporation), but does not want to do any work. This situation results in what is called a Limited Partnership.

The difference between a general partnership and a limited partnership is simply as the name implies. It contains one or more partners who are not fully liable for partnership obligations. There has to be at least one general partner and at least one limited partner in this legal format.

The *general partner* may be an individual, a corporation, or any other legal domestic or foreign entity. The general partner(s) is generally liable for all of the partnership's obligations and debts just like in the general partnership we discussed previously.

A *limited partner* is a partner whose liability is limited to the amount of the partner's share of ownership (i.e. the amount invested into the business). A limited parter contributes financially to the business in exchange for a share of the partnership's profits, but they can't participate in the daily operations or management.

Because the partner gives up management control, a limited partner cannot be forced to pay off business debts with their personal assets. They may lose their financial investment in the partnership, but no more than that.

Limited partnerships may carry on any profit or non-profit business except in the fields of insurance and banking.

Since limited partnerships are governed by state statute, a partnership agreement should be agreed upon and then the partners need to file with the state in which the limited partnership is to be organized. Once filed, state limited partnership laws only comes into play if a matter has to be decided and it is not spelled out in the limited partnership agreement. Courts generally defer to the limited partnership agreement first and state law second.

It should be noted that if the partnership has a loss, the passive-income laws do not allow limited partners to deduct partnership losses on their personal returns. The loss must be carried over each year until such time that it can be deducted against profits that a limited partner receives.

Let's review the pros and cons of Limited Partnerships:

The Pros:

- Liability protection for limited partners.
- Separate entity from partners.
- Ownership can be transferred within the rules of the partnership agreement.
- Limited partners' liability is limited to their investment in the business.
- Limited partners pay self-employment tax on guaranteed payments only. The rest is considered investment income.
- No double taxation of profits like C corporations.

The Cons:

- Must have one general partner with unlimited liability (unless an LLC).
- Limited liability status for damages can be lost for a variety of administration reasons.
- Restrictions on partners based on entity type.
- Requires a separate tax return.
- Requires tracking of basis for partners, both inside and outside the partnership.

Differences

The main differences between a General Partnership and Limited Partnership is the tax treatment and liability of the limited partner.

- Whereas the profits for a general partner are subject to self-employment tax, the profits for a limited partner are considered investment income (unless guaranteed) and are treated the same way as profits from sale of stock.
- A loss passed-down to a limited partner can't be deducted against other income. It must be forwarded to a future year where there is partnership profits to subtract it from.
- A limited partner is only liable for partnership debts up to the amount that they invested in the partnership.

Limited Liability Partnerships

Some states, like Delaware, authorize a special form of a general partnership known as a limited liability partnership. In a limited liability partnership, the partnership is required to register with the Delaware Secretary of State and maintain a specified amount of liability insurance. In return, partners are received of personal liability for the obligations of the partnership.

However, partners do remain personally liable for their own negligence or misconduct and of persons under their direct supervision and control. The limited liability partnership is attractive to professionals who want the benefits of the partnership form but without the personal liability for the professional misconduct of *other* partners and employees.

Since LLPs are registered at the state level, they often have legal and reporting requirements, such as requiring partnership agreements and annual financial reporting requirements. All partners may contribute to the management, however with shared management comes shared liability (even though it is limited).

Most professionals, like attorneys or accountants, pool their resources, experience, and clients together to form a LLP. Doing this lowers the cost of business for each member of the LLP while at the same time increases the potential for growth. This means they make more profit than they would as an independent entity.

Another benefit is that partners can be brought on or retired easier as outlined by the partnership agreement. While this requires approval from all current partners, adding new partners with existing business can bring in new clients and more revenue.

So what's the difference between a Limited Partnership and Limited Liability Partnership?

A limited partnership is a type of partnership that consists of a least one general partner and at least one limited partner. A Limited Liability Partnership does not have a general partner, since every partner in an LLP is given the ability to take part in the management of the company.

Limited Liability Limited Partnerships

Only about have half the states offer the protection accorded under LLLPs. They are basically Limited Partnerships that have extended limited protections for *general partners* against others liability. In a LLLP, no general or limited partner is liable for the partnership's obligations which were created solely by another partner's malfeasance.

Certain states, such as Arkansas and Texas, use a different name for these entities such as Registered Limited Liability Partnerships. In Delaware, a statement of qualification must be filed.

Creating a LLLP is much the same as an LLP. An annual report must be filed and fee paid. In addition, the partnership must have as the last words or letters of its name the words 'Limited Liability Limited Partnership', L.L.L.P. or LLLP.

Professional Corporations

To make sure you have all of your options discussed here, there is an option only available to licensed and learned professionals, such as lawyers, accountants, health care professionals, engineers, psychologists, veterinarians, and social workers.

These used to be more popular in the 1970s and 1980s when the tax advantages associated with a Professional Corporation (PC) were not available through other forms of business entities such as the LLP or LLC. Nonetheless, in some states, PCs are still somewhat popular with people in these professions.

The typical features of a professional corporation are that only licensed professionals may be stockholders/owners of the business entity, each professional participates in the management of the business, and each stockholder remains personally liable for their *own* professional negligence or malpractice.

As you can see, there are a lot of choices in determining which legal format is the right one for your business. Which type of partnership is right for you depends entirely on how to wish to manage business, the degree of liability you are comfortable with, and how you wish to interact with your partners.

Knowing the partnership pros and cons also lets you determine whether it is right for you or you would be more comfortable with a S corporation or C corporation which we will also discuss in this course. But before we get to those, let's finish our consideration of sole proprietorships and partnerships with the final form of liability protection, the Limited Liability Company, in the next module.