

GENERAL AND LIMITED PARTNERSHIPS



General Partnerships

A general partnership, or simply called a partnership, is only a bit more complex than a sole proprietorship. A partnership is considered a relationship between two or more people who own and share the profits of a business. Each of the partners contributes something to the business, whether it is labor, capital, assets or expertise. Each of the partners also shares in the profits or losses of the business.

A partnership can be created with a simple handshake or verbal agreement. However, this is not recommended. At a minimum, you should always create a partnership agreement outlining how the profits and losses of the business should be split, the payment of salaries and the procedure for selling an interest in the partnership.

A partnership must have two or more persons. There is no such thing as a one person partnership. Although there is no legal upper limit on the number of partners, a partnership with many partners is often difficult to manage and reach consensus on decisions.

Advantages

One advantage of a partnership is that it may be easier than a sole proprietor to raise capital for the business. This is because the partners can pool their funds and assets to provide collateral for business loans. However, there is still not as great an advantage as a corporation or LLC has.

A partnership is also relatively easy to form and less expensive than a corporation or LLC. However, a partnership agreement should still be completed and executed by each partner. This simplicity, however, can be deceptive. With a sole proprietorship, the owner knows that his or her actions directly affect the success of the business and that the owner is ultimately responsible. Partnerships are more difficult to manage because the commitments, duties and obligations of each of the partners is often not very well defined. This often leads to difficulties and disagreements on significant decisions that impact the business.

Another potential advantage of the partnership are the tax implications. Here, as with a sole proprietorship, the profits from the business are distributed directly to the partners and reported on each partners individual tax return. Although the partnership does not pay taxes directly, it must still file an information return each year (IRS Form 1065). The partnership must also supply each partner with a completed IRS Schedule K-1 to show the partners proportionate share of the profits or losses.

Disadvantages

As with a sole proprietorship, by far the biggest disadvantage of a partnership is that the owner's personal assets are not protected from the business. In fact, the personal liability can actually be greater that with a sole proprietorship because each owner is individually liable for the business. Thus a creditor can go after any member of the partnership for the entire debt regardless of the ownership percentage. In other words, you can be personally liable for the entire business. Again, that is putting your home, your retirement savings, your car, your children's college funds at enormous risk. You could lose it all. Although you can sue the other partners to recover their fair share of the debt, this is very troublesome and difficult.

Since each partner can act in the name of the business and as the business' agent, your partners can commit the business to contracts and deals. While this may seem simple, realize that any commitments your partners make in the name of the business you are personally liable for. If your partner commits the business to a contract that will result in the business losing millions of dollars, you could be personally liable for the business' obligation. This creates a huge risk to any owner.

In addition to the personal liability considerations above, there is also a concern should one of the partners die. Under almost all circumstances, a partnership is automatically dissolved or terminated upon the death of one of the partners. In such a case, all assets would be accounted for and divided up. This disadvantage may be avoided if a detailed and comprehensive partnership agreement is entered into by the partners when the partnership is formed.

Finally, while a partnership may find it easier than a sole proprietorship to obtain business loans, a partnership cannot raise capital as easy as a corporation. This is because it cannot access the major capital markets through public stock offerings. While this may not be a significant disadvantage to many businesses that intend to stay small, many growing businesses should seriously consider the advantages of raising capital in an easy and efficient manner.

Limited Partnerships

A limited partnership is like a combination of a partnership and a corporation. It is a rather complex form of business entity because there are two types of partners: general partners and limited partners. General partners are one or more persons that manage the business entity and have the same risks and liabilities as a partner in a general partnership (which is a lot of risk and liability). Limited partners are one or more partners that contribute capital to the business. Limited partners do not participate in managing the business and have no personal liability for the business' debts, claims or obligations. Limited partners are similar to shareholders of a corporation.

A limited partnership is formed by filing a Certificate of Limited Partnership with the state and paying initial filing fees. It requires at least two people to form; there must be at least one limited partner and at least one general partner. Because of the complexity of this form of business entity, a competent attorney should be advised and used to draw up the required documentation.

Advantages

For a limited partner, the risk associated with the ownership interest is limited to his or her investment. In other words, a limited partner's personal assets are not at risk for the debts and obligations of the business. They can only lose what they invested in the business.

This limitation of liability and the fact that limited partners do not manage the business makes it easier to raise equity capital in the business. The limited partner investor will share in the benefits of the business' profits (or losses) with fewer of the liability risks. This makes the investment much more attractive.

Disadvantages

While the limited partnership offers limitation of liability to the limited partner, the general partner's personal assets are still at risk as with a general partnership. Thus, the general partner still could lose his or her personal assets should the obligations of the business exceed its assets, such as in the case of creditors or adverse judgments.

Another disadvantage is the inherent complexity of the limited partnership. They are generally formed by filing documents with the state, which creates more paperwork for the owners to form and maintain the limited partnership. Because of the liability concerns to the general partner, limited partnerships are often used as one part of a complex business structure in very large businesses. The complexity required to gain the full benefits of a limited partnership make them beyond the reach of most businesses.

There is also the potential for partnership conflict in a limited partnership. While this conflict is mitigated somewhat by the limited partners distancing themselves from the management, conflict among the general partners is common. If the limited partners do attempt to exercise control over the partnership, they risk losing the benefits of limited liability.