5.3: Partnerships- Sharing the Load

2. What are the advantages of operating as a partnership, and what downside risks should partners consider?

Can **partnerships**, an association of two or more individuals who agree to operate a business together for profit, be hazardous to a business's health? Let's assume partners Ron and Liz own a stylish and successful beauty salon. After a few years of operating the business, they find they have contrasting visions for their company. Liz is happy with the status quo, while Ron wants to expand the business by bringing in investors and opening salons in other locations.

How do they resolve this impasse? By asking themselves some tough questions. Whose view of the future is more realistic? Does the business actually have the expansion potential Ron believes it does? Where will he find investors to make his dream of multiple locations a reality? Is he willing to dissolve the partnership and start over again on his own? And who would have the right to their clients?

Ron realizes that expanding the business in line with his vision would require a large financial risk and that his partnership with Liz offers many advantages he would miss in a sole proprietorship form of business organization. After much consideration, he decides to leave things as they are.

For those individuals who do not like to "go it alone," a partnership is relatively simple to set up. Offering a shared form of business ownership, it is a popular choice for professional-service firms such as lawyers, accountants, architects, stockbrokers, and real estate companies.

The parties agree, *either orally or in writing*, to share in the profits and losses of a joint enterprise. A *written partnership agreement*, spelling out the terms and conditions of the partnership, *is recommended* to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

There are two basic types of partnerships: *general and limited*. In a **general partnership**, all partners share in the management and profits. They co-own the assets, and each can act on behalf of the firm. Each partner also has unlimited liability for all the business obligations of the firm. A **limited partnership** has two types of partners: one or more **general partners**, who have unlimited liability, and one or more **limited partners**, whose liability is limited to the amount of their investment. In return for limited liability, limited partners agree not to take part in the day-to-day management of the firm. They help to finance the business, but the general partners maintain operational control.

There are also limited liability partnerships (LLP), which are similar to a general partnership except that partners are not held responsible for the business debt and liabilities. Another type is a limited liability limited partnership (LLLP), which is basically a limited partnership with addition of limited liability, hence protecting the general partner from the debt and liabilities of the partnership.

Advantages of Partnerships

Some advantages of partnerships come quickly to mind:

- *Ease of formation.* Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a *partnership agreement.* For most partnerships, applicable state laws are not complex.
- *Availability of capital.* Because two or more people contribute financial resources, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources.
- *Diversity of skills and expertise.* Partners share the responsibilities of managing and operating the business. Combining partner skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. To find the right partner, you must examine your own strengths and weaknesses and know what you need from a partner. Ideal partnerships bring together people with complementary backgrounds rather than those with similar experience, skills, and talents. In **Table 4.2** you'll find some advice on choosing a partner.
- *Flexibility.* General partners are actively involved in managing their firm and can respond quickly to changes in the business environment.

- *No special taxes.* Partnerships pay no income taxes. A partnership must file a partnership return with the Internal Revenue Service, reporting how profits or losses were divided among the partners. Each partner's profit or loss is then reported on the partner's personal income tax return, with any profits taxed at personal income tax rates.
- *Relative freedom from government control.* Except for state rules for licensing and permits, the government has little control over partnership activities.

Perfect Partners
Picking a partner is both an art and a science. Someone may have all the right credentials on paper, but does that person share your vision and the ideas you have for your company? Are they a straight shooter? Honesty, integrity, and ethics are important, because you may be liable for what your partner does. Be prepared to talk about everything, and trust your intuition and your gut feelings—they're probably right. Ask yourself and your potential partner the following questions—then see how well your answers match up: 1. Why do you want a partner? 2. What characteristics, talents, and skills does each person bring to the partnership? 3. How will you divide responsibilities—from long-range planning to daily operations? Who will handle such tasks as marketing, sales, accounting, and customer service? 4. What is your long-term vision for the business—its size, life span, financial commitment, etc.? 5. What are your personal reasons for forming this company? Are you looking to create a small company or build a large one? Are you seeking a steady paycheck or financial independence? 6. Will all parties put in the same amount of time, or is there an alternative arrangement that is acceptable to everyone? 7. Do you have similar work ethics and values? 8. What requirements will be in the partnership agreement?

Table4.2

Disadvantages of Partnerships

Business owners must consider the following disadvantages of setting up their company as a partnership:

- *Unlimited liability*. All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets. To overcome this problem, many states now allow the formation of *limited liability partnerships (LLPs),*which protect each individual partner from responsibility for the acts of other partners and limit their liability to harm resulting from their own actions.
- *Potential for conflicts between partners.* Partners may have different ideas about how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Differences in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.
- *Complexity of profit sharing.* Dividing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.
- *Difficulty exiting or dissolving a partnership.* As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. To whom will that share be sold, and will that person be acceptable to the other partners? If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest. Partners can also purchase special life insurance policies designed to fund such a purchase.

Business partnerships are often compared to marriages. As with a marriage, choosing the right partner is critical. So if you are considering forming a partnership, allow plenty of time to evaluate your and your potential partner's goals, personality, expertise, and working style before joining forces.

CONCEPT CHECK

1. How does a partnership differ from a sole proprietorship?
2. Describe the four main types of partnerships, and explain the difference between a limited partner and a general partner.
3. What are the main advantages and disadvantages of a partnership?