

6.7: Partnerships

Learning Objectives

- Define partnerships as a form of business
- Describe the difference between general and limited partnerships
- Discuss the advantages and disadvantages of partnerships



A partnership is a single business in which two or more people share ownership. Each partner contributes to all aspects of the business, including money, property, labor, or skill. In return, each partner shares in the profits and losses of the business.

Because partnerships entail more than one person in the decision-making process, it's important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners), and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended, and it's considered extremely risky to operate without one.

Types of Partnerships

There are two general types of partnership arrangements:

- **General Partnerships** assume that profits, liability, and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.
- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

Forming a Partnership

To form a partnership, you must register your business with your state, a process generally handled through your Secretary of State's office.

You'll also need to establish your business name. For partnerships, your legal name is the name given in your partnership agreement. If you choose to operate under a name different from the officially registered name, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name, short for "doing business as").

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Partnership Taxes

Most businesses will need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit. An additional requirement for partnerships is that they must file an "annual information return" to report the income, deductions, gains and losses from the business's operations, but the *business itself does not pay income tax*. Instead, the business "passes through" any profits or losses to its partners. Partners include their respective share of the partnership's income or loss on their personal tax returns. Like sole proprietors, partners in the partnership are responsible for several additional taxes, including income tax, self-employment tax, and estimated tax. Since partnerships can be complex, having a professional to advise the partnership and partners on tax matters is crucial.

? Practice Questions

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Advantages of a Partnership

- **Easy and Inexpensive.** Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- **Shared Financial Commitment.** In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This can be beneficial in terms of securing credit or by simply doubling the seed money available.
- **Complementary Skills.** A good partnership should capitalize on the benefits of being able to utilize the strengths, resources, and expertise of each partner.
- **Partnership Incentives for Employees.** Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

Disadvantages of a Partnership

- **Joint and Individual Liability.** Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- **Disagreements Among Partners.** With multiple partners, there are bound to be disagreements. Partners should consult one another on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

✓ TW Construction or T&T Construction?

For several months Tareq has been operating as a sole proprietorship and enjoying the control he maintains over his work and finances. Business is picking up and he has recently been contacted by a construction firm that wants to hire him to provide the trim carpentry for several large oceanfront homes they are building. He mentions this to his friend Todd, who seems very happy that Tareq's new business venture appears to be succeeding. A month later, Todd calls and asks Tareq to meet him for dinner at Sandbar's. During dinner, Todd proposes to Tareq that the two of them form a general partnership: T&T Construction. Todd points out that taking on several large jobs as a sole proprietor is very risky—a partnership would mean shared risk and responsibility. He also offers to contribute some initial capital to the newly formed partnership, which would provide financial support for their day-to-day operations. Finally, Todd makes the case that, as a frame carpenter, he has skills that would complement Tareq's and potentially yield additional business opportunities.

Surprised by the proposal, Tareq tells his friend that he needs some time to think it over before committing. During the next few days, he calls his accountant, Luana, to find out how the partnership would impact his business. He learns that he would have to share control of the business and also share the profits. That doesn't sound bad to Tareq, especially if the business really grew—which it might, with the addition of Todd's skills and labor. Tareq is leaning toward accepting the offer.

But when he Luana tells him that he would be held responsible not only for the debts of the business but also the actions of his partner, he sours on the idea. He knows Todd has made some business decisions and deals that were a little on the sketchy side. Under the proposed General Partnership structure, if Todd made similar kinds of decisions or deals—even without Tareq's knowledge—Tareq could be held responsible and liable for the consequences. He's realizes he's not willing to accept that kind of risk. He decides to turn down Todd's offer and keep running his business as a sole proprietor.

? Practice Question

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