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Partnership Basics

Learn more about the simplest business structure for companies with more than one owner.

By definition, a partnership is a business with more than one owner that has not filed papers with the state to become a corporation or LLC (limited liability company). There are two basic types of partnerships: general partnerships and limited partnerships. This article discusses general partnerships, the more common structure in which every partner has a hand in managing the business.

The partnership is the simplest and least expensive co-owned business structure to create and maintain. However, there are a few important facts you should know before you begin.

Personal Liability for All Owners

First, partners are personally liable for all business debts and obligations, including court judgments. This means that if the business itself can't pay a creditor, such as a supplier, lender, or landlord, the creditor can legally come after any partner's house, car, or other possessions.

There are a few exceptions to this personal liability. Some of the partners can have limited personal liability if the partnership is set up as a limited partnership. This is a partnership in which only the general partner, who runs the business, has personal liability, while the limited partners, who are basically passive investors, can lose no more than their stake in the partnership. Also, some states allow special limited liability partnerships (LLPs). More commonly, though, businesspeople who are particularly concerned about personal liability choose to incorporate their business or operate as a limited liability company (LLC).

Joint Authority

In addition, any individual partner can usually bind the whole business to a contract or other business deal. For instance, if your partner signs a year-long contract with a supplier to buy inventory at a price your business can't afford, you can be held personally responsible for the money owed under the contract.

There are just a few limits on a partner's ability to commit the partnership to a deal -- for instance, one partner can't bind the partnership to a sale of all of the partnership's assets. But generally, unless an outsider has reason to know of any limits the partners have

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placed on each other's authority in their partnership agreement, any partner can bind the others to a deal.

Joint Liability

Each individual partner can be sued for -- and required to pay -- the full amount of any business debt. If this happens, an individual partner's only recourse may be to sue the other partners for their shares of the debt.

Because of this combination of personal liability for all partnership debt and the authority of each partner to bind the partnership, it's critical that you trust the people with whom you start your business.

Partnership Taxes

A partnership is not a separate tax entity from its owners; instead, it's what the IRS calls a "pass-through entity." This means the partnership itself does not pay any income taxes on profits. Business income simply "passes through" the business to the partners, who report their share of profits (or losses) on their individual income tax returns. In addition, each partner must make quarterly estimated tax payments to the IRS each year.

While the partnership itself doesn't pay taxes, it must file IRS Form 1065, an informational return, each year. This form sets out each partner's share of the partnership profits (or losses), which the IRS reviews to make sure the partners are reporting their income correctly.

Creating a Partnership

You don't have to file any paperwork to establish an ordinary partnership -- just agreeing to go into business with another person will get you started.

Of course, partnerships must meet the same local registration requirements as any new business. Most cities and counties require businesses to register with them and pay at least a minimum tax. You may also have to obtain an employer identification number from the IRS, a seller's license from your state, and a zoning permit from your local planning board.

In addition, your partnership may have to register a fictitious or assumed business name. If your business name doesn't contain all of the partners' last names (for instance, you want to use "London Landscapes" instead of "Harper & Reed Landscapes"), you usually must register that name -- known as a fictitious or assumed business name -- with your county clerk.

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While the owners of a partnership are not legally required to have a written partnership agreement, it makes good sense to put the details of ownership, including the partners' rights and responsibilities and their share of profits, into a written agreement.

Ending a Partnership

One disadvantage of partnerships is that when one partner wants to leave the company, the partnership generally dissolves. In that case, the partners must fulfill any remaining business obligations, pay off all debts, and divide any assets and profits among themselves.

If you want to prevent this kind of ending for your business, you should create a buy-sell agreement, or buyout agreement, which can be included as part of your partnership agreement. A buy-sell/buyout agreement helps partners decide and plan for what will happen when one partner retires, dies, becomes disabled, or leaves the partnership to pursue other interests. For example, such an agreement might allow the partners to buy out a departing partner's interest, so business can continue as usual.

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