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NebFact

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Setting Up Your Own Business: The Partnership

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by Paul H. Gessaman, Extension Economist

This is one in a series of **NebFacts** providing information on the principal forms of business organization used by small businesses. A broad overview of the advantages, limitations, and tax implications of each form of business organization is included. Titles in the series are listed at the end of each NebFact.

Your need for legal and tax advice: While the information contained in this document is thought to be accurate, it should not be used as a substitute for legal advice on matters related to business organization, taxation, estate planning, or other business and financial management matters. Consult with your legal and tax advisers before making decisions.

Form of business organization:

The partnership is a popular and useful form of business organization. A partnership is an association of two or more persons formed to carry on a business for profit. As such, it is a special form of business entity separate from the individuals (partners) and is owned by two or more persons each of whom has a specified ownership interest. There are two forms of partnership: the **General Partnership** and the **Limited Partnership** – information on selected characteristics of these two forms of partnership is provided in this document. Consult your attorney for complete information on the suitability to your situation of either of these forms of partnership.

Most business partnerships are organized as general partnerships. In many, the partners are related by blood or by marriage. All partnerships should be based on a written partnership agreement. While many partnership agreements are informal (not compiled in written form), the lack of a written agreement can result in extremely damaging conflicts between partners when a disagreement arises.

With very limited exceptions, a partnership is not an income tax paying entity. All profits and losses pass through to the partners' individual tax returns in proportion to their respective ownership interests. Unless continuity of the partnership is provided for in the partnership agreement, a partnership is

dissolved upon the death or withdrawal of one of the partners. Unless the partnership debt to asset ratio is very low, borrowing usually requires loan documentation signed by all partners and their respective spouses (if any).

No public notice of the partnership agreement is required at the time of formation of a **general partnership** – public notice may be required if a partner subsequently is added to the partnership. Public notice of the formation of a **limited partnership** must be given through registration with the Corporation Division of the Secretary of State's office.

Advantages of a partnership:

Principal reasons for the popularity of partnerships include:

- Partnerships are an easy way of assembling enough financial and physical resources to make it possible to establish or continue a business.

- Unless the partnership agreement contains restrictive provisions that prevent doing so, partners in a **general partnership** can specialize in aspects of management and operations that capitalize on their skills and interests.

- Only the general partner of a **limited partnership** can participate in management making possible the limitation of liability for the limited partners.

- When all partners sign debt instruments, the borrowing capacity of a partnership may be greater than the total borrowing capacity of the partners as individuals.

- For any given level of complexity and size of operation, the cost of establishing a partnership is relatively low and record keeping needs are relatively easily satisfied.

- Record-keeping and income tax filing requirements are only slightly more onerous than for individuals.

- Opportunities for family members to work together in starting or operating a business are relatively unlimited.

Limitations of a partnership:

Partnerships have a number of limitations with important implications for the partners and members of their families. These include, but are not restricted to:

- In a **general partnership** all assets of each partner are at risk while in a **limited partnership**, all assets of the general partner are at risk and capital invested by the limited partners is at risk.

- Any partner in a **general partnership** and the **general partner** of a **limited partnership** can enter into contracts and incur obligations that are binding on all partners.

- Unless the partnership agreement contains specific provisions authorizing continuation, a general partnership ends upon the death of any partner – usually resulting in disruption of ongoing business arrangements.

- Any general partner can require dissolution of the partnership at any time.
- Partners holding a minority interest can be alienated if general partners holding a majority of the ownership interest consistently vote as a block and the interests of minority partners are ignored.
- Unless succession is carefully planned, each generation must purchase or inherit the interests of each partner – subject to associated estate and inheritance tax costs.
- Division of management responsibility among the partners can result in no one having an overall understanding of the financial standing of the partnership.
- For a number of social and economic reasons, it may be difficult to enter an existing partnership.
- It may be very difficult to get out of a partnership without undue financial loss and/or interpersonal conflict with the other partners.
- Conflicts or disagreements among the partners can immobilize business decision making causing loss of productivity and profitability.

A carefully drafted partnership agreement can reduce or avoid many of these limitations. However, a partnership agreement cannot alter the financial responsibilities that accompany being a general partner or a limited partner as they are defined by statutes and court decisions.

Tax implications - general:

All real and personal property held by a partnership is taxable to the extent set by Nebraska law. Partnership income or loss, including capital gains, pass through to the partners in proportion to their respective partnership interests and is taxed as income to the receiving individuals. Partnership income is subject to state and federal income tax and, as applicable, to self-employment tax. Cash wages paid to partnership employees are subject to payroll taxes in the same manner as is the case for employees in any other type of economic activity.

Partners may have taxable gains if they move assets into the partnership and the partnership a) apportions to them a partnership interest greater than the tax basis of the assets, or b) the partnership assumes responsibility for previous debt payable on the assets. Partners also may incur taxable gains on distributions from the partnership if the distribution of assets and liabilities is not in the same proportions as the respective partnership interests. Tax reducing opportunities typical of those afforded to sole proprietorships are available. Unless carefully done, liquidation of partnership interests may result in large tax liabilities as tax implications for general partners are very nearly the same as for sole proprietors. The transfer of a partial partnership interest to another person must be approved by the other partners, and may be a taxable transaction if the value of the interest transferred exceeds the tax-free gift amount.

Gift tax and estate tax implications:

All aspects of the gift tax, estate tax, and inheritance tax are the same as those applicable to any individual. Gifting of tangible assets outside the partnership as a means of utilizing the nontaxable gift allowance of up to $10,000 per recipient per year (up to $20,000 for a joint gift by husband and wife) can be very difficult as assets with the correct value often are difficult to identify. Gifting may be feasible only if the prospective donor has financial ability to make such gifts without reducing

partnership involvement and without disrupting outside-the-partnership business activities and personal life.

If all partners agree, or if authorized by the partnership agreement, gifting fractional partnership interests in annual amounts less than the tax-free limits may be advantageous. The gift of a partnership interest may be made very simply by noting the transfer in the partnership interest account. Thus, partnerships may be a convenient way to transfer property ownership from one generation to the next in a way similar to the transfer of corporate stock.

Estate planning can provide a plan for minimizing the legal and tax costs of orderly transfer of business and personal assets to successors. If you are considering gifting or other partnership interest transfers be certain to secure and follow the recommendations of your legal and tax advisers when planning and implementing the gift or transfer.

Cooperative Extension publications in this series:

- NF 96-253 *Setting Up Your Own Business: The Sole Proprietorship*
- NF 96-254 *Setting Up Your Own Business: The Partnership*
- NF 96-255 *Setting Up Your Own Business: The "S" Corporation*
- NF 96-256 *Setting Up Your Own Business: The "C" Corporation*
- NF 96-257 *Setting Up Your Own Business: The Limited Liability Company*

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