BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for 29 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

PARTNERSHIP

by Mary Hanson

Operating a business as a general partnership has a number of serious disadvantages. They are serious enough to warrant a general recommendation against the use of a general partnership for almost any type of business.

The key concern is that a partnership does not provide the protection from personal liability that is provided by the use of an entity (such as a corporation, a limited partnership, and a limited liability company). In addition, the partnership form exposes each partner to liabilities and obligations created by other partners.

While some individuals may be willing to risk personal liability by operating a business as a sole proprietorship, few individuals should be willing to face the risks involved in a business operated by two individuals (a partnership) in which both have authority to enter into obligations, the right to make management decisions, and the possibility of causing accidents.

The greatest risks of the partnership form arise from obligations to – or claims of – third parties. Such claims can arise from contracts, loans, employment, nonpayment of taxes, accidents, and defective products or poor quality services to customers.

Under California law, partners are agents of the partnership, and as an agent, each has the power to make commitments on behalf of the partnership. A partner can enter into binding agreements, hire and fire employees, accept orders, extend credit, etc. Under California law, even where a partnership agreement, or a "statement of partnership" filed with the Secretary of State tries to limit the authority of a partner, the authority is only truly limited if the affected third party knows of the limitation on authority. Consequently, the acts of a partner are usually binding.

One partner's poor business decision making, poor judgment, poor negotiation ability, or poor management ability can doom the partnership and also expose all partners to significant liability.

The liability the partners face is "joint and several liability", which means that each partner is personally liable for the debts, taxes, claims, and other liabilities of the business – and each can be held responsible for 100% of a partnership liability, even if the partner's interest in the business is only a small percentage. Even if you have an agreement that all liabilities shall be shared equally, that agreement does not prevent your being sued by a third party for the entire obligation of the partnership.

No agreement between you and your partner will stop a third party from suing you. An agreement with your partner just gives you a right to sue the partner to reimburse you – for his or her portion of liability in

"No agreement between you and your partner will stop a third party from suing you."

accordance with the agreement. This is far less than ideal for a number of reasons. If your partner doesn't have adequate resources, there may be no point in pursuing him or her, no matter what your agreement says.

Here's a list of a number of reason for avoiding the partnership form for the business:

(1) A partner has the legal ability to create liabilities to third parties for which all partners are liable.

(2) A partnership is formed, by law, when two or more persons act as co-owners of a business. The undesirable aspects of partnership apply, even where the individuals explicitly agree NOT to have a partnership.

(3) Since a partnership can be formed informally, a partnership may be created without the benefit of any partnership agreement. Without a partnership agreement, the rights and obligations of the partners are unclear. Even when state partnership law sets out rights and obligations of partners regarding distributions of profit, sharing of losses, reimbursement of partners for partnership expenses, and other matters, the state law will not provide all the agreements, understandings, limitations, policies and procedures that are needed. The law is inadequate to be the basis for operation of a partnership.

(4) Under the law, a partner can be held 100% liable for a partnership liability, even if that partner's interest in the business is only a small percentage. This is because each partner is personally liable for the debts, taxes, and claims against the business. The law leaves it up to the partner to pursue the other partners for their share of the liability.

(5) Claims can be made against any partner by vendors, customers, employees, and others affected by the business, arising out of contracts, loans, employment, nonpayment of taxes, accidents, and poor products or services to customers.

(6) If one partner is mismanaging the business, the law does not enable the other partner to just get rid of the partner or take over management of the business. The legal remedies involve going to court to obtain relief based on the partnership agreement or violation of the law.

(7) The tax treatment and state laws regarding financial rights of partners are based on partnership accounting. Many business owners, and even some accountants, are confused by partnership accounting. This can add to misunderstandings and disagreements related to taxes and financial matters.

(8) Because partners must actually define their own management procedures and details of the partnership structure, and must set up books to maintain partnership capital accounts, the partnership structure is often more complex, not less complex, than a corporation.

(9) Without a detailed partnership agreement, partners can have difficulty insisting that a particular partner perform certain work, contribute additional capital, or split liabilities. A partner may have to seek dissolution of the partnership in order to resolve a dispute. A partnership agreement is the appropriate place to set out the rights

and obligations of partners along with management methods and dispute resolution procedures that may avoid drastic legal remedies.

(10) All partners are taxed on partnership profits, according to their ownership interests, whether those profits are distributed or not. If a business is using up cash and profits are reinvested or used to repay debt, the partners can end up paying a lot of personal taxes on income that they personally never received. The tax consequences can be very unpleasant.

(11) Partnership income is subject to self-employment taxes. Just as an individual pays taxes of 15.3% toward social security and medicare on all sole proprietorship income, all partners in a general partnership pay those "self-employment taxes" on his or her percentage of taxable partnership income – including the income that was not distributed to the partners!

Partnership Advantages

Any of the "advantages" that a business owner might find in the partnership form of business can be obtained from other entities that also provide a level of protection from personal liability. The use of a general partnership is not necessary to obtain the advantages of "the partnership form of business."

The main advantage of the partnership form is the "flow through" tax treatment that flows the tax consequences of the business to the participants according to their percentage interests, providing for one level of tax, rather than taxes at both the entity level and the individual level.

Limited liability companies, limited partnerships, and limited liability partnerships, are all partnerships from a tax treatment standpoint and provide the same tax benefits that a general partnership does. But they also provide meaningful limitations on personal liability for business activities. The S corporation, although a corporation, is taxed like a partnership for most purposes, similarly providing the flow through tax treatment while also providing protection from personal liability.

The other key advantage of the partnership form is the ability to creatively structure the business management and control in an agreement rather than having management and control defined by law, as it is in a corporation. The limited liability company, limited partnership, and limited liability partnership form also offer this advantage.

Other Partnership Disadvantages

In addition to the disadvantages of operating as a partnership, the overall disadvantages of having co-owners should be considered. Here are some of the top reasons for not having co-owners:

(1) Each co-owner will have his or her own ideas on management and business decisions. His or her ideas are unlikely to be the same as your ideas. His or her style of management may be very different from yours. His or her style of management is most likely NOT the same as yours.

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Publisher's Note

If you are the key person in a new business, make sole ownership a key objective.

Avoid the general partnership form of business.

Only go into a co-ownership situation if the business simply cannot exist without the financial contribution of the other person. Even then, make sure the financial contribution is substantial and will be made before the individual obtains any ownership interest.

If it is SERVICES you want from another person, you are better off hiring the individual. An ownership interest does not assure the other person's performance. You need to be able to replace the individual if they do not perform, and to have control over the services provided.

Mary Hanson
Attorney/Publisher

(2) Sharing decision-making is difficult. Do you really want to share decision-making when it regards your most important asset (the business) and your source of income?

(3) If you are stuck in an unhappy business relationship, it can be very difficult to get "divorced." It cannot be ended without some co-operation from your co-owner – or even court action.

(4) Your co-owner's financial situation is most likely different from yours. It is unlikely that you and another co-owner will have the same lifestyle, income needs, financial obligations, and tax circumstances. Serious conflicts can arise based on either putting money into the business or taking money out.

(5) Differences in vision must be expected. Your co-owner may want to sell the business when you want to expand the business or may want to invest in some new activity when you think the business should be sold. Your co-owner may want to be paid more, or work less, or give his brother-in-law, girlfriend, children, or other people jobs.

Conclusion

The best advice is to avoid the general partnership form of business. If, after discussion with your accountant, you DO want the tax benefits of a partnership form of business, use one of the forms of business that provide the desired tax benefits and also provide protection from personal liability. BA

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FROM THE LAW OFFICE OF MARY HANSON
21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

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