Partnership Form of Organization

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. Partnerships are sometimes used in small retail, service, or manufacturing companies. Also accountants, lawyers, and doctors find it desirable to form partnerships with other professionals in the field.

Characteristics of Partnerships

**STUDY OBJECTIVE 1**

Identify the characteristics of the partnership form of business organization.

Partnerships are fairly easy to form. People form partnerships simply by a verbal agreement, or more formally, by written agreement. We explain the principal characteristics of partnerships in the following sections.

**Association of Individuals**

A partnership is a legal entity. A partnership can own property (land, buildings, equipment), and can sue or be sued. A partnership also is an accounting entity. Thus, the personal assets, liabilities, and transactions of the partners are excluded from the accounting records of the partnership, just as they are in a proprietorship.

The net income of a partnership is not taxed as a separate entity. But, a partnership must file an information tax return showing partnership net income and each partner's share of that net income. Each partner's share is taxable at personal tax rates, regardless of the amount of net income each withdraws from the business during the year.

**Mutual Agency**
**Partnership Form of Organization**

**Mutual agency** means that each partner acts on behalf of the partnership when engaging in partnership business. The act of any partner is binding on all other partners. This is true even when partners act beyond the scope of their authority, so long as the act appears to be appropriate for the partnership. For example, a partner of a grocery store who purchases a delivery truck creates a binding contract in the name of the partnership, even if the partnership agreement denies this authority. On the other hand, if a partner in a law firm purchased a snowmobile for the partnership, such an act would not be binding on the partnership. The purchase is clearly outside the scope of partnership business.

![Mutual Agency](image)

**Limited Life**

Corporations have unlimited life. Partnerships do not. A partnership may be ended voluntarily at any time through the acceptance of a new partner or the withdrawal of a partner. It may be ended involuntarily by the death or incapacity of a partner. **Partnership dissolution** occurs whenever a partner withdraws or a new partner is admitted. Dissolution does not necessarily mean that the business ends. If the continuing partners agree, operations can continue without interruption by forming a new partnership.

![Limited Life](image)

**Unlimited Liability**

Each partner is **personally and individually liable** for all partnership liabilities. Creditors' claims attach first to partnership assets. If these are insufficient, the claims then attach to the personal resources of any partner, irrespective of that partner's equity in the partnership. Because each partner is responsible for all the debts of the partnership, each partner is said to have **unlimited liability**.

![Unlimited Liability](image)
Co-Ownership of Property

Partners jointly own partnership assets. If the partnership is dissolved, each partner has a claim on total assets equal to the balance in his or her respective capital account. This claim does not attach to specific assets that an individual partner contributed to the firm. Similarly, if a partner invests a building in the partnership valued at $100,000 and the building is later sold at a gain of $20,000, the partners all share in the gain.

Partnership net income (or net loss) is also co-owned. If the partnership contract does not specify to the contrary, all net income or net loss is shared equally by the partners. As you will see later, though, partners may agree to unequal sharing of net income or net loss.

Organizations with Partnership Characteristics

If you are starting a business with a friend and each of you has little capital and your business is not risky, you probably want to use a partnership. As indicated above, the partnership is easy to establish and its cost is minimal. These types of partnerships are often called regular partnerships. However if your business is risky—say, roof repair or providing some type of professional service—you will want to limit your liability and not use a regular partnership. As a result, special forms of business organizations with partnership characteristics are now often used to provide protection from unlimited liability for people who wish to work together in some activity.
The special partnership forms are: limited partnerships, limited liability partnerships, and limited liability companies. These special forms use the same accounting procedures as those described for a regular partnership. In addition, for taxation purposes, all the profits and losses pass through these organizations (similar to the regular partnership) to the owners, who report their share of partnership net income or losses on their personal tax returns.

### Limited Partnerships

In a **limited partnership**, one or more partners have **unlimited liability** and one or more partners have **limited liability** for the debts of the firm. Those with unlimited liability are **general partners**. Those with limited liability are **limited partners**. Limited partners are responsible for the debts of the partnership up to the limit of their investment in the firm.

The words “Limited Partnership,” or “Ltd.,” or “LP” identify this type of organization. For the privilege of limited liability, the limited partner usually accepts less compensation than a general partner and exercises less influence in the affairs of the firm. If the limited partners get involved in management, they risk their liability protection.

### Limited Liability Partnership

Most states allow professionals such as lawyers, doctors, and accountants to form a **limited liability partnership** or “LLP.” The LLP is designed to protect innocent partners from malpractice or negligence claims resulting from the acts of another partner. LLPs generally carry large insurance policies as protection against malpractice suits. These professional partnerships vary in size from a medical partnership of three to five doctors, to 150 to 200 partners in a large law firm, to more than 2,000 partners in an international accounting firm.

### Limited Liability Companies

A hybrid form of business organization with certain features like a corporation and others like a limited partnership is the **limited liability company**, or “LLC.” An LLC usually has a limited life. The owners, called **members**, have limited liability like owners of a corporation. Whereas limited partners do not actively participate in the management of a limited partnership (LP), the members of a limited liability company (LLC) can assume an active management role. For income tax purposes, the IRS usually classifies an LLC as a partnership.
Limited Liability Companies Gain in Popularity

The proprietorship form of business organization is still the most popular, followed by the corporate form. But whenever a group of individuals wants to form a partnership, the limited liability company is usually the popular choice.

One other form of business organization is a subchapter S corporation. A subchapter S corporation has many of the characteristics of a partnership—especially, taxation as a partnership—but it is losing its popularity. The reason: It involves more paperwork and expense than a limited liability company, which in most cases offers similar advantages.

Why do you think that the use of the limited liability company is gaining in popularity?

Answer:

The LLC is gaining in popularity because owners in such companies have limited liability for business debts even if they participate in management. As a result, the LLC form has a distinct advantage over regular partnerships. In addition, the other limited type partnerships discussed in Illustration 12-1 are restrictive as to their use. As a result, it is not surprising that limited liability companies are now often used as the form of organization when individuals want to set up a partnership.

Illustration 12-1 summarizes different forms of organizations that have partnership characteristics.
Illustration 12-1  Different forms of organizations with partnership characteristics

Advantages and Disadvantages of Partnerships

Why do people choose partnerships? One major advantage of a partnership is to combine the skills and resources of two or more individuals. In addition, partnerships are easily formed and are relatively free from government regulations and restrictions. A partnership does not have to contend with the “red tape” that a corporation must face. Also, partners generally can make decisions quickly on substantive business matters without having to consult a board of directors.

On the other hand, partnerships also have some major disadvantages. **Unlimited liability** is particularly troublesome. Many individuals fear they may lose not only their initial investment but also their personal assets, if those assets are needed to pay partnership creditors.

Illustration 12-2 summarizes the advantages and disadvantages of the regular partnership form of business organization. As indicated in the previous section, different types of partnership forms have evolved to reduce some of the disadvantages.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combining skills and resources of two or more individuals</td>
<td>Mutual agency</td>
</tr>
<tr>
<td>Ease of formation</td>
<td>Limited life</td>
</tr>
<tr>
<td>Freedom from governmental regulations and restrictions</td>
<td>Unlimited liability</td>
</tr>
<tr>
<td>Ease of decision making</td>
<td></td>
</tr>
</tbody>
</table>

**Illustration 12-2**  Advantages and disadvantages of a partnership

The Partnership Agreement

**Ethics Note**

A well-developed partnership agreement reduces ethical conflict among partners. It specifies in clear and concise language the process by which the partners will resolve ethical and legal problems. This issue is especially significant when the partnership experiences financial distress.

Ideally, the agreement of two or more individuals to form a partnership should be expressed in a written contract, called the **partnership agreement** or **articles of co-partnership**. The partnership agreement
Partnership Form of Organization

contains such basic information as the name and principal location of the firm, the purpose of the business, and date of inception. In addition, it should specify relationships among the partners, such as:

1. Names and capital contributions of partners.
2. Rights and duties of partners.
3. Basis for sharing net income or net loss.
4. Provision for withdrawals of assets.
5. Procedures for submitting disputes to arbitration.
6. Procedures for the withdrawal or addition of a partner.
7. Rights and duties of surviving partners in the event of a partner's death.

We cannot overemphasize the importance of a written contract. The agreement should attempt to anticipate all possible situations, contingencies, and disagreements. The help of a lawyer is highly desirable in preparing the agreement.

Accounting Across the Organization

How to Part Ways Nicely

What should you do when you and your business partner do not agree on things, to the point where you are no longer on speaking terms? Given how heated business situations can get, this is not an unusual occurrence. Unfortunately, in many instances the partners do everything they can to undermine the other partner, eventually destroying the business. In some instances people even steal from the partnership because they either feel that they “deserve it” or they assume that the other partners are stealing from them.

It would be much better to follow the example of Jennifer Appel and her partner. They found that after opening a successful bakery and writing a cookbook, they couldn't agree on how the business should be run. The other partner bought out Ms. Appel's share of the business, and
Ms. Appel went on to start her own style of bakery, which she ultimately franchised.

How can partnership conflicts be minimized and more easily resolved?

**Answer:**

*First, it is important to develop a business plan that all parties agree to. Second, it is vital to have a well-thought-out partnership agreement. Third, it can be useful to set up a board of mutually agreed upon and respected advisors to consult when making critical decisions.*


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**Before You Go On...**

**Review It**

1. What are the distinguishing characteristics of a partnership?

2. What are the principal advantages and disadvantages of a partnership? Why is **PepsiCo** not a partnership?

**Answer:**

Mutual agency, limited life, unlimited liability, and co-ownership of property are major characteristics of a partnership. As a company like **PepsiCo** becomes very large, it becomes difficult to remain as a partnership because of these factors. Unlimited liability is particularly troublesome because owners may lose not only their initial investment but also their personal assets, if those assets are needed to pay partnership creditors. Also, it is much easier to change owners of a corporation than it is to change owners in a partnership.

3. What is the difference between a regular partnership and a limited liability company?

4. What are the major items in a partnership agreement?