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Partnerships and Debt

If you're a partner in a business then your personal assets may be at risk if the business fails. It all depends on what kind of partnership you're involved with.

In the US there are no standard Federal laws governing the formation of a partnership. While each state is generally free to regulate partnership laws on their own, the Internal Revenue Service has created a fairly detailed scheme for taxing partnerships under 26 USC 1 subsection K that effectively acts like a federal code to regulate partnerships.

There are three types of partnerships in the US, general partnerships, limited partnerships, and limited liability partnerships. Each has its advantages and disadvantages when it comes to dealing with the liabilities of the partners for the partnership's debt.

A general partnership is the simplest form a partnership can take. In law a partnership is an agreement between two or more people to carry out a business for profit. Each general partner is jointly and severally liable for their own debts and for the debts of the partnership.

This means that if the partnership cannot pay their debts as they come due, a creditor can collect the entire amount of the debt from one partner. In a general partnership, liability for partnership obligations cannot be contractually limited. Therefore, if you are a partner in a business and the partnership's debts become more than the assets the partnership owns your personal assets are at risk.

In a limited partnership (LP) there are two types of partners. The general partner acts exactly like a partner in a general partnership and has the same rights and responsibilities. And the same liability for the partnership's debts. The limited partner(s) is more like a stockholder in a corporation. A limited partner is only liable for the debts of the partnership up to the amount of their investment in the partnership. Therefore it is safer to be a limited partner than a general partner.

Limited liability partnerships (LLPs) the newest form of partnerships. In some states, like California and New York, LLPs can only be formed as professional organizations like a law firm or a medical association.   The liability of the partners for the partnership's debt varies from state to state, but most states that allow LLPs have adopted the Revised Uniform Partnership Act (a group of model rules and not statutory) that treats LLPs like corporations.

Commercial debt is not the only type of debt a partnership may be faced with. Liability for taxes, especially income tax debt can cause the partners and the partnership problems if not handed appropriately. As with the rules that govern partnerships in each state, each state treats partnerships differently with guidance from the Federal Tax code.

A general partnership is not treated as a separate entity for Federal Tax purposes. Under 26 USC 1 Subsection K, each partner is taxed on the amount of their distributive share. For example if a partnership consists of two partners, Ralph and Ed. The agreement says Ralph is entitled to 40% of the profits and Ed is entitled to the other 60%. This means the IRS will tax Ralph on the 40% he is entitled to even if no distribution was made to Ralph during that tax year.

In a limited partnership or a limited liability partnership, a limited partner has the same tax liability as a general partner. This means that just like a general partner, a limited partner has to pay income taxes on their share of the partnership profit. Conversely, this also means that a limited partner can write off their share of the partnership's losses just like a general partner.

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