

LLCs and Partnerships Tax Info Sheet (2010)

FEDERAL INCOME TAX

In this Tax Info Sheet, except where otherwise indicated, "LLC" can be substituted for "partnership," and "member" (LLC owner) can be substituted for "partner." This is so because, unless they elect to be taxed as corporations, multi-member LLCs are treated as partnerships for federal income tax purposes. Single-member LLCs are generally ignored as an entity separate from their owner for federal income tax purposes.

Classic Case for a Partnership

A partnership can be formed under state law to pursue any lawful business or investment opportunity. The "classic" situation calling for the use of a partnership to operate a proposed venture is one in which:

- 1) Achieving pass-through taxation is a critical goal.
- 2) Some or all owners are prohibited from being S corporation shareholders.
- 3) The S corporation single-class-of-stock rule prevents the owners from holding the types of ownership interests they want.

What Is a Partnership?

Definition	A business or investment venture conducted jointly by two or more participants (partners) with the intent to divide the income and profits from the undertaking.
Joint Ventures	Partnerships with limited business purposes (for example, to develop and sell a specific parcel of real estate or drill and operate an oil well) are commonly termed <i>joint ventures</i> .
Legal Aspects	These are governed by state partnership statutes, most of which are in conformity with the Uniform Partnership Act (UPA) and the Revised Uniform Limited Partnership Act (RULPA).
Liability Limitation	Using a limited partnership and/or liability insurance can often offer the partners virtually the same level of liability protection as enjoyed by corporate shareholders and LLC members.
Tax Advantages	From a federal income tax perspective, partnerships offer the advantage of freedom from double taxation (<i>pass-through taxation</i>) without the need to worry about meeting the strict S corporation eligibility rules.

Partnership Formation Essentials

General Partnerships	<ul style="list-style-type: none"> • A partnership is a business or investment venture conducted jointly by two or more participants (partners) dividing the income and profits. • A general partnership can exist for state law purposes even though there is no formal partnership agreement or other document. • Most states' general partnership laws conform to the Uniform Partnership Act (UPA). Partners can include individuals (other than minors or insane persons) and virtually any type of entity, including LLCs, trusts, corporations and other partnerships.
Limited Partnerships	<ul style="list-style-type: none"> • Limited partnerships usually must file a certificate of limited partnership with the appropriate state or local office, describe the business the partnership will conduct, describe the partnership's financial structure and designate the general and limited partners' names. • To qualify as a limited partnership, the entity must comply with requirements of the state's limited partnership statute. Failing that, an intended limited partnership is treated as a general partnership for legal purposes, and all partners are treated as general partners. • In most states, limited partnerships are governed by law conforming to the Revised Uniform Limited Partnership Act (RULPA).
Importance of Having a Partnership Agreement	<ul style="list-style-type: none"> • Partnership agreements allow partnerships to, in effect, write their own laws regarding how their affairs will be conducted. • Although a partnership can function without a written partnership agreement, it is certainly not recommended. • At the least, a partnership agreement should specify how the entity will be managed; the legal relationships between the partners; the partners' obligations to make contributions; the partners' shares of profits, losses and distributions; the allocations of tax items; the partners' withdrawal rights; and so forth.

LIMITING PARTNER'S LIABILITY

The issue of a partner's legal liability with respect to the partnership's activities is a matter of state law. Competent legal advice should always be sought for liability questions. However, the following generalizations usually apply.

General Partnerships

- A general partner is jointly and severally liable for all debts and obligations of the partnership, including those arising from errors, omissions and negligence of other partners and employees.
- Each general partner also has the authority to legally bind the partnership (and indirectly the other general partners), another potential source of liability exposure for general partners.
- A general partner's liability is personal in nature, so an individual general partner's personal assets are potentially exposed to partnership debts and obligations without limitation.

Limited Partnerships

A limited partnership must have at least one general partner with unlimited liability. This factor puts limited partnerships at an obvious disadvantage compared to C and S corporations. Corporate stockholders generally are not at risk to lose anything beyond the value of their stock investments. However, many shareholders of closely held corporations are required by lenders to personally guarantee corporate debts. This means that the limited liability advantage of corporations often may be more apparent than real.

Limiting the general partner's liability. A relatively simple way to work around the general partner's unlimited liability problem is to form a limited partnership with an S corporation or LLC as the sole general partner.

- The S corporation or LLC typically is owned by the individuals (and in the same proportions) who will actually manage the limited partnership's activities.
- These owners are protected from personal liability exposure by the entity's liability-limiting powers. All they have at-risk in a worst-case scenario is the value of their equity interests in the general partner entity.
- All the other partners are limited partners to begin with.
- The net effect of using a corporate or LLC general partner is that all owners are protected from unlimited personal exposure to the liabilities of the partnership.
- Because the S corporation or LLC general partner is itself a pass-through entity, the benefits of pass-through taxation are still available to all owners.
- The downside of using a corporate or LLC general partner is the expense to create an additional legal entity and the related administrative and tax filing burdens.

Potential loss of liability protection. Under applicable state law, a limited partner who takes an active role in the management of a limited partnership risks losing limited partner status. This makes limited partnerships unsuitable for certain activities, such as the practice of a profession where all partners are by definition heavily involved. If the inability of limited partners to participate in management is unacceptable, consider LLCs, LLPs, C corporations or S corporations.