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Risks of Operating as a General Partnership

I. What is a General Partnership?

If a business has two or more owners, and the owners have not formed a legal entity, they are operating a general partnership. There is no requirement to file initial organizational documents or annual reports with the Secretary of State's office. Accordingly, if two people are working together and running a business jointly and sharing the profits of the business they are a general partnership.

II. What are the consequences of a general partnership with respect to an owner?

A. Management and Decision-Making.

A key characteristic of a general partnership is that each partner has the right to manage, and make decisions about the business, unless the partners have an agreement providing otherwise. This means that each partner individually can bind the business to contracts, incur business debts and subject the business to other liabilities – even without the other partner's knowledge or consent. Under this business organization, general partners must be able to persuade their co-owners to agree to certain business policies, rules or ideas.

The only way to elect out of this equal management structure is to sign a general partnership agreement among all partners. The agreement can specify who has the power to bind the partnership (and who does not) and whose consent is required when it comes to different management decisions. Nonetheless, a partner can still bind the partnership in violation of the agreement and potentially result in liability for other partners.

B. Liability.

Each partner in a general partnership is personally liable for the obligations and liabilities of the partnership. Those obligations and liabilities include debts of the business (e.g., loans and contractual liabilities) incurred by other partners - even if without your knowledge or consent. They also include any other type of liability incurred by the business, including those resulting from accidents or other liabilities of the business resulting from litigation.





If the business fails, or cannot pay, its obligations, creditors are permitted to seek payment from the personal assets of any one of the partners (usually, they will go after the one with the most assets). Those liabilities could exceed the total amount of investment each partner has put into the business and expose your personal assets (home, savings, etc.) to the rights of the creditors of the partnership.

C. Tax.

A general partnership is considered a pass-through entity by the IRS, which means that the IRS does not recognize it as a taxable entity. This means that the business itself is not taxed. Instead, profits are only taxed at the individual partner level (i.e., on your personal income tax return) and losses flow through to the individual partners as well.

A general partnership needs to file federal and state tax returns for information purposes and provides a Schedule K-1 to each partner. The K-1 informs the partner of such partner's pro rata share of the business profit or loss that must be included on the partner's personal income tax return.

If a general partnership does not have a written agreement, the profits or losses will be allocated among the parties in accordance with their oral agreement, and lacking an oral agreement, the profits and losses will be allocated proportionately among the partners, subject to certain rules under the tax code.

III. How to properly form a general partnership.

For the above stated reasons, it is usually not recommended to run a business as a general partnership. Nevertheless, if you decide that a general partnership is the right structure for your business, it is strongly advised that you enter into a written partnership agreement that is signed by all partners. The partnership agreement should outline the economics of the business (i.e. what portion of the business income each owner ("partner") will be entitled to) as well as setting rules or guidelines for how business and financial decisions are made. We suggest that you seek advice from lawyers and tax advisors in drafting any partnership agreement.

Instead of operating a business as a partnership, we recommend that you take the steps necessary to form a legal entity (corporation or LLC), because a legal entity generally provides more protection to its owners than does a general partnership. If you are already going to





make the effort to draft a partnership agreement to define your rights (as stated above, we recommend doing this), most of the work necessary to form an LLC will be the same. The effort to form an LLC and the cost will be approximately the same, and the owners of the business have greater protection from liabilities of the business and more defined management responsibilities. See our note on LLCs here¹.

This guide was generously prepared by WilmerHale.

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¹ Step-By-Step Guide to Forming a Limited Liability Company,
<https://www.legalfoodhub.org/resource/step-by-step-guide-to-forming-a-limited-liability-company/>

