

Starting a Business - Partnerships

You recently informed us that you are considering forming a partnership to run a business and requested that we explain the legal and tax considerations involved in operating in that fashion.

Unlike a corporation, a partnership is not a taxable entity. Rather, each partner is taxed directly on his or her share of partnership profits or losses. This is an advantage over operating as a corporation where profits could be taxed twice, once at the corporate level and again at the owner level when dividends are distributed to shareholders.

A new business often has losses in the early years. By operating as a partnership, you can use your share of the partnership's losses to offset income from other sources, such as investments and compensation from employment. However, to be able to deduct losses currently, you must satisfy the so-called passive activity loss (PAL) rules. As a general rule, as long as you materially participate in the business conducted by the partnership, you will meet the PAL rules.

A partner is not considered an employee of the partnership. Instead, partners pay self-employment tax on the partnership income. One component of self-employment tax is the Social Security portion, which is computed on earnings up to \$118,500 for 2016, and the Medicare portion, which has no upper limit.

One legal downside of operating as a partnership is that general partners are exposed to unlimited liability from lawsuits that arise in connection with the business even when they are based on the acts or omissions of a partner. This is to be contrasted with operating a business as a corporation where, as a general rule, only the corporation's funds are at risk.

Fortunately, you do not have to forgo the tax advantages of operating as a partnership to limit your potential liability. You can operate as an S corporation to minimize your liability exposure and yet be taxed similarly (but not identically) to the way you would be taxed if you operated as a partnership. Another option is the limited liability company. With this choice, your liability exposure also would be reduced and you would be taxed even more like a partnership than if you operated as an S corporation.

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