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ACCOUNTING

Partnerships Are a Tricky Business

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Small business ownership can be daunting when you're alone at the top. That's why many entrepreneurs consider forming their businesses as equal partnerships between two or more owners. However, these business structures can be uniquely affected by relationships, taxes, and other factors.

An equal partnership can be a great idea until it isn't. Perhaps the partnership is between a couple, siblings, or colleagues. Maybe it's a partnership from the beginning, or it's an idea that allows two or more inheritors of a family business to share the business equally.

Equally sharing a business may sound like it will keep the peace, but, eventually, it can result in turmoil. Some of the most significant challenges come into play when:

- A partner becomes disillusioned by a real or perceived belief that they're doing more work than the other(s).
- One partner drops the ball in their duties, participates in fraud, or decides to pivot in a direction that wasn't discussed initially.
- Family changes for one partner affect the whole. For example, divorce and death can both lead to one partner's stake suddenly being transferred to or shared with a spouse or former spouse outside the original ownership group.
- Generational chaos ensues. Passing down a family business equally to offspring can result in too many cooks in the kitchen, complicating operations and decision making.

While partnerships can lead to these challenges, they aren't inherently a bad idea. However, they need to be structured and executed thoughtfully.

Have the Tough Conversations

A partnership begins because two (or more) owners each bring something unique to the table. That could be talent or expertise, money or property, or a tireless work ethic (sweat equity). These different values mean that the partnership—from the start—isn't equal (based on sameness) but should at least be equitable (based on fairness). Outlining these expectations from day one is essential.

Of course, you should have a shared vision, too. Do you plan on growing the business? Do your short-term and long-term goals match? What about financial responsibility: Who will handle business finances, bookkeeping, payroll, and tax filings? When the business generates a profit, how will that be distributed? If it doesn't do well, is every partner prepared to take on debt?

Once you start having these discussions and evaluating each partner's contributions, you're likely to realize two critical things. First, perhaps an equal partnership isn't appropriate after all. Another type of partnership that distributes ownership more equitably based on roles/responsibilities might be better. And second, you're going to need some help wrangling these moving parts into a strategic plan that transcends a verbal agreement.

Make it Legal

This realization should lead you to build a structure around the partnership you envision. One pillar is your legal formation. A general partnership is always an option, but it provides little liability protection for owners. Limited partnerships and limited liability partnerships are often better options for this reason. Within those partnership structures, you can divide partnership levels in many ways. For example, maybe there should be a managing partner who is given authority to act on behalf of the other partners in certain situations.

It's essential to work with a legal professional to hammer out these details in a partnership agreement. Just as important is drawing up a buy-sell agreement from the start. It's not a frivolous contingency because the partnership is guaranteed to change at some point for one reason or another. A buy-sell agreement can help you avoid surprises or conflict when it happens.

Consider the Tax & Financial Implications

Partnerships and the IRS have a complicated history. The entities are passthrough, which means the partners, not the business, are taxed. This has resulted in some tax advantages that the IRS has spent years trying to rein in.

Before 2018, for instance, for small partnerships with ten or fewer partners, the IRS could only audit each partner, not the entity. This complication resulted in very few audits—perhaps less than 1% of partnerships each year. The Bipartisan Budget Act (BBA) became law in 2018 and gave the IRS the ability to audit and collect money from partnerships directly (unless the partners proactively opt-out). Around the same time, the Tax Cuts and Jobs Act of 2017 (TCJA) increased the excludable qualified business income of passthroughs to 20%, and partnerships became even more irresistible. But recently proposed legislation aims at reducing deductions and loopholes.

The bottom line is that as tax laws change, so might the advantages/disadvantages of a partnership. It also hammers home the point that you need to trust those you partner with. If one partner commits fraud concerning their business earnings, the IRS may be able to take a close look at the other partners. Were you grossly negligent in overlooking your partner's discretions? Did you profit from their actions?

And even if you choose a protected partnership structure with limited liability, you and your partners need to make smart financial moves to keep your business and personal assets clearly separate. Personal guarantees, offering up collateral, and co-mingling business and personal finances at any point can come back to bite you if the business goes bankrupt or has unpaid debt.

Many of these considerations are best discussed directly with a business attorney and tax professional before instituting a partnership agreement. A little due diligence from the start can go a long way in keeping a healthy partnership long-term.

Steven Bankler has more than 45 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.