

What are partnerships and limited liability companies?

Some business owners choose to create partnerships or limited liability companies instead of a corporation. A partnership can also be called a firm, and refers to an association of a group of individuals working together in a business or professional practice.

While corporations have rigid rules about how they are structured, partnerships and limited liability companies allow the division of management authority, profit sharing and ownership rights among the owners to be very flexible.

Partnerships fall into two categories. General partners are subject to unlimited liability. If a business can't pay its debts, its creditors can demand payment from the general partners' personal assets. General partners have the authority and responsibility to manage the business. They're analogous to the president and other officers of a corporation.

Limited partners escape the unlimited liability that the general partners have. They are not responsible as individuals, for the liabilities of the partnership. These are junior partners who have ownership rights to the profits of the business, but they don't generally participate in the high-level management of the business. A partnership must have one or more general partners.

A limited liability company (LLC) is becoming more prevalent among smaller businesses. An LLC is like a corporation regarding limited liability and it's like a partnership regarding the flexibility of dividing profit among the owners. Its advantage over other types of ownership is its flexibility in how profit and management authority are determined. This can have a downside. The owners must enter into very detailed agreements about how the profits and management responsibilities are divided. It can get very complicated and generally requires the services of a lawyer to draw up the agreement.

A partnership or LLC agreement specifies how profits will be divided among the owners. While stockholders of a corporation receive a share of profit that's directly related to how many shares they own, a partnership or LLC does not have to divide profit according to how much each partner invested. Invested capital is only one of the factors that are used in allocating and distributing profits.