The National Agricultural Law Center

Business Organizations Reading Room

General Partnerships

Rusty Rumley
Staff Attorney

Introduction

The basic definition of a general partnership is that it occurs when two or more individuals come together with each person contributing money, labor, property, or skill and each expecting to share in both the profits and losses of the business. However, there is no legal requirement that a partnership arrangement be formalized in writing, which can cause severe problems. It is entirely possible to enter into a partnership unknowingly and to operate for a significant period of time before ever becoming aware of what a court would determine to be the existence of a general partnership. Each and every partner in this business structure, when acting on behalf of the partnership, has the ability to bind the other partners as well as the partnership itself to a contract and expose both the partnership and the partners to civil or even criminal liability.

The ease of formation, the potential liability that faces the partners, the tax structure of the business, and a general partnership's dissolution are all important issues to consider when considering this form of business structure.

Formation

The general partnership form of business structure can be created without filing any legal documents. In this way it is similar to the sole proprietorship in that it is extremely easy to form and can be created without any intention to do so. Evidence of two or more individuals involved in a common enterprise (business) and sharing the profits is often enough for courts to find that a partnership exists. Because of this, a business may start out as a sole proprietorship and change into a partnership by adding in another owner. The other person entering into the business does not have to buy their way in. Contributing labor, property, or a unique skill may be enough for a court to recognize that a partnership exists.

For example, say a farmer needs help on the farm, but does not have the cash on hand to pay an employee. Instead the farmer makes an arrangement with an individual where, instead of hourly wages, the farmer will give the individual a portion of the crop each year for their service. If this scenario continues for a significant period of time before the individual finally decides to move on, the farmer may find himself as an unknowing member of a general partnership. At this point it would be up to a court to divide up the farm's assets in a fair manner between the farmer and the individual who labored for a portion of the crop each year.

Liability

The liability that a partner in a general partnership is exposed to is very similar to the personal liability that a sole proprietor suffers, but also includes an added element of risk. Like a sole proprietorship, the partners are personally responsible for the actions and debts of the partnership, so each partner may lose not only their interest in the partnership assets, but also everything that they personally own. This is called "personal liability," and it means that if the partnership fails or is sued than the creditors can go after both the assets of the general partnership and also after the private assets of the partners. The added element of risk comes in, however, because you, as a partner, are responsible not only for your actions, but for your partner's actions. This is because, in a general partnership, the actions of one partner are imputable to the other partners through "joint and several liability." Each general partner is treated like an agent of the rest of the partners. Essentially this means that the actions and mistakes of one of the partners may become the responsibility of the rest of the partners.

Example: Three friends named Rich, Poor, and Clumsy start a small agricultural business where they share the profits of enterprise equally. All three of the partners live up to their names and one day Clumsy is involved in an accident while working on a job for the business. This accident severely injures Sue. Sue lives up to her name and brings suit against both the general partnership and Clumsy himself for the accident. Because of joint and several liability, Sue can collect not only from Clumsy and the partnership, but also the other partners individually. Clumsy does not have any money and neither does Poor. This means that Rich is going to have to pay for Clumsy's accident, even though it occurred through no fault of his own.

The fact that all partners are potentially responsible for the actions of every other partner makes this type of business structure risky for all of the partners. As a result, many partnerships choose to either adopt the Limited Partnership or the Limited Liability Partnership structures if they wish to do business as a partnership, in an effort to avoid some of the potential liability.

Tax Structure

Essentially, a general partnership is viewed by the IRS as two or more sole proprietors equally responsible for the business. Unless there is a partnership agreement in existence that states otherwise, the partners will share the profits and the debts of the partnership equally between them. If there are two partners in a general partnership, each will take one half of the profits and expenses and include them on their personal income tax return just as if they were a sole proprietor. However, most partnerships are not comprised of partners who all contribute equally to the business. As a result, it is possible to draw up a partnership agreement which divides the business up accordingly. However, even under such an agreement the individual partners must include the relevant tax information into their own personal income taxes just as they would under a sole proprietorship.

Dissolution of a General Partnership

Termination of the partnership depends upon the type of general partnership that the business is operating under. If no formal partnership agreement was ever signed than the partners are operating under the default general partnership rules of that state. The default general rule is that if any partner (whether there is one partner or one hundred partners) dies, becomes disabled, or withdraws from the partnership than the general partnership ends. If the remaining partners carry on with the business than another default general partnership may be created to take the place of the old partnership. If the general partnership was created under a partnership agreement than the agreement itself may set out ways in which the partnership can be terminated. Many of these agreements will contain language that guarantees the continued existence of the partnership even if a partner dies, becomes disabled, or withdraws from the partnership. Large partnerships would be impossible to maintain otherwise as partners moved into and out of the partnership. In these cases the partnership agreement will often state that some specific number of partners can either withdraw or choose to disband the partnership in order to end the business.

Conclusion

While the general partnership business structure is in place throughout the United States, it varies from state to state. Because state law influences the partnership arrangement, it is important to carefully examine the laws of the state where the partnership is located. No matter the state, there are some general principles that apply to general partnerships almost everywhere. A binding partnership agreement can successfully modify most of the problems that occur when entering into a general partnership. In the absence of an agreement then the default provisions of the state where the partnership exists will control. If this happens, one partner can bind the rest of the partners to contracts or debts that are accrued for the partnership and can potentially expose all of the partners to civil and criminal liability for that partner’s actions. Additionally, without other agreement, this type of business structure can be broken very easily, since the loss of one partner is enough to end the business. The almost limitless potential liability coupled with the ease in which the business can be dissolved make the general partnership a risky business structure to use without some form of modification or formalization in place to mitigate these weaknesses.