

CLIENT REPORT

Starting a Business—Partnerships

Dear Client:

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. However, the partnership can set up a qualified retirement plan and other types of benefit plans that cover partners as well as employees.

Since a partner is not an employee, a partner does not pay social security taxes like employees do. However, partners pay the equivalent of social security taxes in the form of two components of self-employment tax, which can be very steep. One component is 12.4% of net earnings up to \$90,000 (inflation-adjusted figure for 2005) and the other is 2.9% of all net earnings. However, you get to deduct one-half of the total tax that you pay. These taxes count just like regular social security taxes in determining the social security benefits you or a family member may become eligible for based on your earnings record.

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.

If you have any questions, please do not hesitate to call.

Sincerely yours,

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