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LAW FIRM

Business Partnership Agreements

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You have all heard the term "Partnership" in relation to business arrangements. On TV and in the movies, young lawyers grind it out, hoping to someday "make partner." But what does it all mean?

In a law firm, for example, aspiring partners are invited into the fold by the existing partners, usually on a "buy-in" basis. Instead of merely earning a salary, a new partner pays an agreed buying figure to the other partners, and the lawyer who then just "made partner" is rewarded with more responsibilities, more stress, and hopefully more income as they now share in the profits of the operation as a whole.

But beneath the vague TV and movie concept of Partners are much more formal arrangements. In Canada, there are generally three types of partnerships that are legally recognized:

1. General Partnership (GP)

This is the simplest form of partnership where all partners are usually equally responsible for the ownership and management of the business, but a partnership can also specify a proportional ownership instead of equal. The general partnership is a popular choice for small and medium-sized businesses because it's relatively easy and economical to set up.

These partnerships are <u>not</u> a separate legal entity from their partners, however, like a corporation. Because they are not a separate legal entity, they don't pay business taxes as a business – rather profits pass through to partners who report them on their personal tax returns.

Forming such a general partnership is simple and cheaper but it comes with risks. If the business racks up debts, creditors can go after the personal assets of the partners who are fully liable for its obligations. Profits must be split among the partners which doesn't always reflect their individual effort or contribution. Bank financing can be tricky, and financing a partnership largely comes from the partners' own wallets or own credit.

2. Limited Partnership (LP)

This structure has two kinds of partners: general partners who manage the business and have full liability, while limited partners are like "silent partners" who invest but do not run the business, making them only liable for the amount they put in.

Limited partnerships are ideal for investors who want to contribute capital without taking on liability or management responsibilities. Like other partnerships, income flows to the partners and is taxed at their individual rates.

One of the drawbacks of a limited partnership is that the general partners are fully exposed to any debts, obligations, or acts of the partnership. Creditors can act against the general partners' personal assets if the company incurs debts. Another disadvantage is that limited partners have no decision-making power. Profit sharing may be unequal and there can be tension between the partners when roles and expectations are not clearly defined from the outset.

Setting up a limited partnership is more complex and costly than forming a general partnership. It also requires regulatory and reporting requirements, and non-compliance can result in penalties or loss of limited liability protection.

3. Limited Liability Partnership (LLP)

Limited Liability Partnership has two or more partners who share resources, profits and management responsibilities. Unlike in a general partnership, partners are not personally liable for the debts of the LLP or for the actions of other partners. However, they are still accountable for their own actions and for obligations directly under their control.

While an LLP is generally considered a separate legal entity from its partners – it can own assets, enter contracts, sue or be sued in its own name, it is still taxed on a flow through basis to the individual partners.

These partnerships are more complex, and Provincial or Federal regulations may also restrict who is eligible to form an LLP based on the industry or province. In Canada, LLPs are commonly used by lawyers and medical professionals for example.

The importance of Partnership Agreements

Whether you're starting a small business with your best friend or entering a high-stakes giant law firm, it is essential to have a partnership agreement in place. This legal document outlines how your partnership will operate, defining roles, responsibilities, ownership, profit-sharing, and exit strategies.

A proper agreement should cover not only the basics such as business name, location, purpose, start date, and nature of the business, but it should also clearly define each partner's duties, authority, and financial contributions to avoid future conflict. Other essentials include how profits/losses are shared, banking details, how partners can join or leave, and what happens if the business dissolves.

Before drafting a business partnership agreement, it is important to identify the type of partnership that best fits your business needs. Consulting a lawyer or accountant is recommended, as each partnership structure carries distinct legal and tax implications.

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