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Tax

Tax treatments of partnerships and LLPs

By **David Rotfleisch**

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(September 28, 2017, 8:24 AM EDT) -- This is part two of a three-part series about the tax treatment of various forms of operation for law firms. Last week's article was on sole proprietorships and associations

Law firm partnership

The other historical, and previously only method of operation of a law firm with multiple equity owners, is a general partnership. Partnerships are creatures of the common law, although the rules have now been codified in statute, and exist whenever persons carry out business in common with a view to profit. While a partnership is not a separate person in law, unlike a corporation, it does have an existence separate and apart from the individual partners. The accounting and taxation are more complex.

A partnership keeps its own sets of books and has to prepare its own set of financial statements. As with all professionals, as a result of the federal budget changes in March 2017, it will now have to value work in progress (WIP) in computing income. It is also required to maintain a calendar year-end.

However, it does not file partnership income tax returns as partnerships are not a taxable entity for income tax, although it will have to file GST/HST returns. It may also have to file a partnership information return (T5013). Instead, the partnership will allocate its net income to all of the partners according to the formula in the partnership agreement. Individual partners will have to report their allocated share of partnership income on their personal tax returns.

With partnerships, the concept of a draw is very relevant to cash flow. Partners are usually paid a regular draw by the partnership. However, these draws are not taxable and only represent cash flow and usually are completely separate from a partner's share of income as allocated on the partnership financial statements. In other words, a partner pays tax on allocated income, not cash flow. That income could be higher than cash flow, if cash is being maintained in the partnership for the purchase of capital assets or cash reserves, or the income may be less than cash flow if previous profits are being paid out or if borrowings were made and paid to the partners.

The key takeaway is that the financial statement income allocation will determine ultimate tax liability, not cash draws received.

Limited liability partnership

A limited liability partnership is solely a creation of statute and exists to limit the exposure of individual partners to the actions of other partners. While partners of a regular partnership are each jointly and severally liable for the debts (or negligence) of the entire partnership, the rules for a limited liability partnership mitigate this harsh general partnership rule. It can be looked at as a hybrid between a general partnership and a full limited partnership, where each limited partner is only liable to the extent of their capital investment. In an LLP, each partner is usually only exposed to liability for their own negligence. The tax treatment of an LLP is identical to that of a general partnership. So, the LLP will prepare financial statements and allocate income to each partner. The individual partners will report that allocated income on their personal tax returns, irrespective of draws allocated during the year.

This is part two of a three-part series about the tax treatment of various forms of operation for law firms. Read part one here.

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