

Sole Proprietorships and Partnerships

by Sophia



WHAT'S COVERED

In this lesson, you will look at three types of business entities through the lens of an example scenario. Specifically, this lesson will cover:

1. Sole Proprietorships

Let's assume that after her first summer running Lily's Landscaping, Lily decides that it's time to take her business to the next level. Currently, she is running her business as a **sole proprietorship**, which is the simplest type of business entity.

It consists of one owner, Lily, and, as the owner, Lily is responsible for every decision, reaps all of the profits and reports them on her individual tax return, and (here's the downside), she alone is responsible for all business debts and contracts. This means that she and the business are one and the same.

If the business incurs liability or debt, it will come out of Lily's personal assets. If the business is sued, it is sued in Lily's name, and she is solely liable for any judgments entered against the business. Many businesses start out as sole proprietorships and later grow into more complex entities.

Keep in mind that a sole proprietorship, however, is not always a tiny business. Many of them are large because the sole proprietorship can hire employees and operate under a registered fictitious name. Nevertheless, it is still solely run, owned, taxed, and sued in the name of the owner.



TERM TO KNOW

Sole Proprietorship

A business that is owned by one individual alone. This business and the individual who owns the business are one and the same and there is no separation between them, and the owner is fully liable for the business.

2. General Partnerships

Back to Lily. She has gathered a lot of expertise in running the operations in her business, from placing orders with suppliers to scheduling workers for client projects.

She realizes, however, that she's not very good at marketing or accounting, and that if her business is to grow,

she needs to bring someone on board who can create a strong brand and strategy for growth, as well as keep good records of her accounts so that she can plan for the future. Fortunately, her good friend Adam is a double major in accounting and marketing, and after a series of discussions, Adam and Lily decide to run Lily's Landscaping together.

Lily and Adam have formed a **general partnership**. The moment they agreed to run Lily's Landscaping together, and to share in the profits and losses of the business together, the partnership was formed. Although their partnership agreement is oral (not written), most general partnerships are formed formally, with partners writing down their agreement in a special type of contract known as a partnership agreement. This is not required, but certainly recommended.

In the absence of a formal agreement, they will still have a partnership. The agreement can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but they can modify this if they wish. As in a sole proprietorship, there is no state involvement in creating a general partnership because there is no separation between the business and the partners— they are legally the same.

A general partnership is taxed just like a sole proprietorship. The partnership is considered a disregarded entity for tax purposes, so income “flows through” the business to the partners, who then pay ordinary income tax on the business income. The partnership may file an information return, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners.

It's been said that a business partnership is like a marriage, and the most important decision is to choose a trustworthy partner. This is because any action taken by one partner in a partnership is binding on all of the other partners, even if they did not all agree to the action.

This is considered one of the downsides to a partnership— full liability by all partners for any debts, judgments, contracts, or liabilities that befall the business. Creditors may collect against all partners or any one of them, including their personal assets. This is called **joint and several liability**.



BIG IDEA

The simplicity and ease of formation of general partnerships make them attractive, but the unlimited liability of their owners makes them risky. Particularly in a partnership, this risk can fall on one partner who may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts. The partnership agreement cannot alter this condition because it can only make agreements between partners, not the outside parties who sue the business.



TERMS TO KNOW

General Partnership

An unincorporated association formed by two or more individuals to carry on business, both of whom are personally liable for all debts of the partnership.

Joint and Several Liability

Liability characterized by the ability of a creditor to sue one or all of the parties at the creditor's option.

2a. Ending a General Partnership

General partnerships are dissolved as easily as they are formed. To sell the partnership or to change the make-up of partners, the partnership is simply dissolved and a new partnership formed.

The assets from the first partnership are transferred to the new partnership. Unlike corporations, partnerships are not transferred with stock or shares. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner.

A common issue that arises is how to value the withdrawing partner's share of the business. The partnership agreement will typically include a buy/sell provision, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner (or the spouse or heir if the partner dies).

CASE STUDY: *Dawson v. White & Case*

After a nearly twenty-year career, Evan Dawson was a partner at a major New York City law firm, White & Case. In 1988, the firm tried to persuade him to withdraw as a partner, but he refused. In July of that year, the other partners in the firm voted to dissolve the partnership and then immediately re-formed again, without Dawson as a partner. He had effectively been fired as a partner from a general partnership. Dawson filed a suit against White & Case for an "accounting," claiming that the **goodwill** of the law firm should be part of the valuation of the partnership.

The common law in New York at the time was that professional partnerships like law firms have no goodwill. The reasoning behind the rule is that as professionals, law firm partners develop and cultivate their own goodwill with clients, and if a partner leaves the firm then the goodwill leaves with that partner. The New York Court of Appeals, in its opinion on this case, held that unless the partnership agreement states otherwise, goodwill is indeed an asset of the partnership and has to be distributed when the partnership is dissolved.

[You can access more details on the case here](#)



TERM TO KNOW

Goodwill

In business, the intangible qualities of a business that give it a good reputation; goodwill is considered to have monetary value.

3. Limited Partnerships

Let's assume that the general partnership formed by Lily and Adam flourishes and becomes profitable. To grow the landscaping business, they want to bring in Lily's wealthy uncle as a partner.

The uncle, however, is worried about unlimited liability. In this case, they can form a **limited partnership**. A limited partnership has both general partners and at least one limited partner. In this case, Lily and Adam will remain as general partners in the business, but the uncle can become a limited partner and enjoy limited liability.

As a limited partner, the most he can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are prohibited from participating in day-to-day management of the business.



TERM TO KNOW

Limited Partnership

An unincorporated association formed by two or more individuals to carry on business, and at least one partner is relieved of personal liability for the debts of the partnership, in compliance with special state laws that allow this. The limited partner's liability is limited to his or her investment in the partnership.



SUMMARY

In this lesson, you learned that a **sole proprietorship** is an individual owning and operating a business with no legal formalities, and a **general partnership** is formed when two or more persons agree to share profits and losses in a joint business venture. Sole proprietorships and general partnerships are not considered to be separate legal entities, and the owners have unlimited liability. **Ending a general partnership** involves transferring assets to a new partnership or redistributing them among the remaining partners. General partners can also bring in limited partners, creating a **limited partnership**. Limited partners enjoy limited liability, but cannot participate in day-to-day management of the business.

Best of luck in your learning!

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