

18.2: Reading- Sole Proprietorship and Partnerships

Sole Proprietorship

A **sole proprietorship** is a business owned by only one person. The most common form of ownership, it accounts for about 72 percent of all U.S. businesses^[1]. It's the easiest and cheapest type of business to form: if you're using your own name as the name of your business, you just need a license to get started, and once you're in business, you're subject to few government regulations.

Advantages and Disadvantages of Sole Proprietorships

As sole owner, you have complete control over your business. You make all important decisions, and you're generally responsible for all day-to-day activities. In exchange for assuming all this responsibility, you get all the income earned by the business. Profits earned are taxed as personal income, so you don't have to pay any special federal and state income taxes.

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control, for example, is having to supply all the different talents that may be necessary to make the business a success. And if you die, the business dissolves. You also have to rely on your own resources for financing: in effect, you *are* the business, and any money borrowed by the business is loaned to *you personally*. Even more important, the sole proprietor bears **unlimited liability** for any losses incurred by the business. As you can see from Figure 1, the principle of unlimited personal liability means that if the *company* incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the *owner* is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

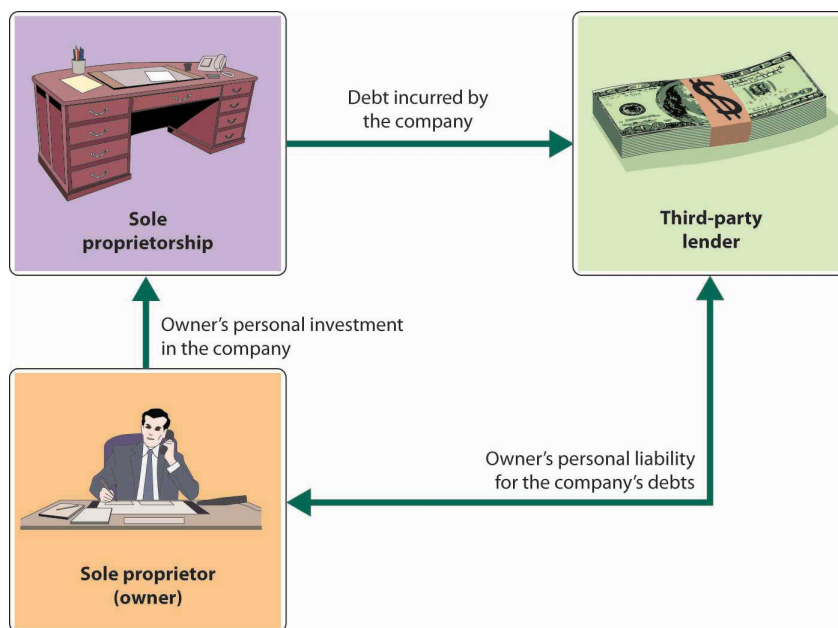


Figure 18.2.1: Sole Proprietorship and Unlimited Liability

Partnership

A **partnership (or general partnership)** is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships^[2], and though the vast majority are small, some are quite large. For example, the accounting firm Deloitte, Haskins and Sells is a partnership. In 2014 it had revenues of \$34.2B and 210,000 employees.^[3]

Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice. Professionals can help you identify and resolve issues that may later create disputes among partners.

The Partnership Agreement

The impact of disputes can be lessened if the partners have executed a well-planned *partnership agreement* that specifies everyone's rights and responsibilities. The agreement might provide such details as the following:

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what
- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

Unlimited Liability and the Partnership

Figure 2 shows that a major problem with partnerships, as with sole proprietorships, is unlimited liability: each partner is personally liable not only for his or her own actions but also for *the actions of all the partners*. In a partnership, it may work according to the following scenario. Say that you're a partner in a dry cleaning business. One day, you return from lunch to find your establishment on fire. You're intercepted by your partner, who tells you that the fire started because he fell asleep while smoking. As you watch your livelihood go up in flames, your partner tells you something else: because he forgot to pay the bill, your fire insurance was canceled. When it's all over, you estimate the loss to the building and everything inside at \$1.2 million. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, *you can be personally sued for the amount owed*. In other words, any party who suffered a loss because of the fire can go after your personal assets.

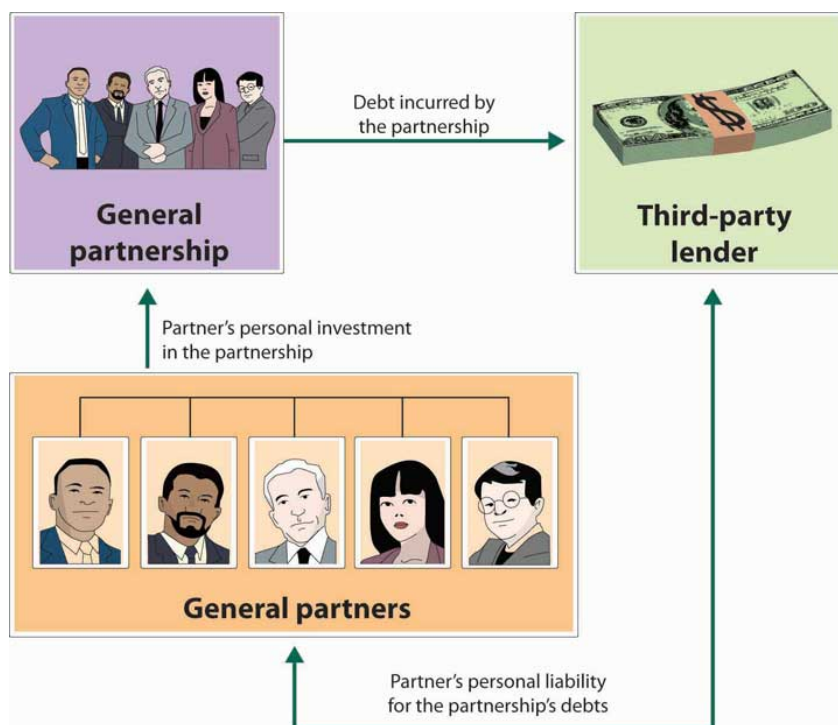


Figure 18.2.2: General Partnership and Unlimited Liability

Limited Partnerships

Many people are understandably reluctant to enter into partnerships because of unlimited liability. Individuals with substantial assets, for example, have a lot to lose if they get sued for a partnership obligation (and when people sue, they tend to start with the richest partner). To overcome this defect of partnerships, the law permits a **limited partnership**, which has two types of partners: a single **general partner** who runs the business and is responsible for its liabilities, and any number of *limited partners* who have limited involvement in the business and whose losses are limited to the amount of their investment.

Advantages and Disadvantages of Partnerships

The partnership has several advantages over the sole proprietorship. First, it brings together a diverse group of talented individuals who share responsibility for running the business. Second, it makes financing easier: The business can draw on the financial

resources of a number of individuals. The partners not only contribute funds to the business but can also use personal resources to secure bank loans. Finally, continuity needn't be an issue because partners can agree legally to allow the partnership to survive if one or more partners die.

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of actual conflict; in fact, they can even jeopardize the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case.

While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.

KEY TAKEAWAYS

- A sole proprietorship is a business owned by only one person.
- It's the most common form of ownership and accounts for about 72 percent of all U.S. businesses.
- Advantages of a sole proprietorship include the following:
 - Easy and inexpensive to form; few government regulations
 - Complete control over your business
 - Get all the profits earned by the business
 - Don't have to pay any special income taxes
- Disadvantages of a sole proprietorship include the following:
 - Have to supply all the different talents needed to make the business a success
 - If you die, the business dissolves
 - Have to rely on your own resources for financing
 - If the company incurs a debt or suffers a catastrophe, you are personally liable (you have unlimited liability)
- A general partnership is a business owned jointly by two or more people.
- About 10 percent of U.S. businesses are partnerships.
- The impact of disputes can be reduced if the partners have a partnership agreement that specifies everyone's rights and responsibilities.
- A partnership has several advantages over a sole proprietorship:
 - It's relatively inexpensive to set up and subject to few government regulations.
 - Partners pay personal income taxes on their share of profits; the partnership doesn't pay any special taxes.
 - It brings a diverse group of people together to share managerial responsibilities.
 - Partners can agree legally to allow the partnership to survive if one or more partners die.
 - It makes financing easier because the partnership can draw on resources from a number of partners.
- A partnership has several disadvantages over a sole proprietorship:
 - Shared decision making can result in disagreements.
 - Profits must be shared.
 - Each partner is personally liable not only for his or her own actions but also for those of all partners—a principle called **unlimited liability**.
- A limited partnership has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

Reflection Questions

- Would you prefer to carry the full weight of a business, or to trust a partner?

Check Your Understanding

Answer the question(s) below to see how well you understand the topics covered in this section. This short quiz does **not** count toward your grade in the class, and you can retake it an unlimited number of times.

Use this quiz to check your understanding and decide whether to (1) study the previous section further or (2) move on to the next section.

<https://assessments.lumenlearning.com/assessments/186>

1. Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, accessed January 27, 2012 ↵
2. Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, accessed January 27, 2012 ↵
3. www.deloitte.com/view/en_GB/uk/about/our-history/index.htm ↵

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