

# CPA BEC - STUDY UNIT 1

## Proprietorships and General Partnerships: Core Concepts

### A. Sole Proprietorships

1. The **sole proprietorship** consists of one individual engaged in any kind of business. It is not distinct from its owner and is not a separate legal entity. The sole proprietorship is easy and cheap to create. Most filing, registration, and attorneys' fees are avoided. It is formed at the will of the proprietor.
  - a. A major weakness is that it cannot raise **equity capital** other than the personal resources of the proprietor.
  - b. The proprietor has the advantage of receiving all profits. (S)he has the disadvantage of **unlimited personal liability**. The income/loss of the business is reported by the proprietor. The proprietor receives the tax benefits of all business deductions and losses.
  - c. **Operation** of the sole proprietorship is flexible. The proprietor has authority to make all management decisions. The duration of the sole proprietorship is at the proprietor's discretion.
  - d. It is automatically terminated upon the proprietor's death.

### B. General Partnerships

1. **Definition.** A **partnership** is "an association of two or more persons to carry on as co-owners of a business for profit."
2. In a **general partnership**, each partner has **unlimited personal liability** for all losses and debts of the business.
3. A partnership is an entity distinct from the partners (owners). However, a partnership is treated as an **aggregate** of the individual partners in some ways: (a) A partnership lacks continuity of existence, (b) no person can become a partner without consent of all the partners, (c) debts are ultimately the debts of the individual partners, and (d) a partnership is not subject to regular federal income tax.
4. **Formation.** A general partnership can be created without formalities. Its existence may arise from a written or oral agreement or be implied by the conduct of the parties. If the partnership is to exist for a definite period exceeding one year, the partnership agreement must be in writing. The **partnership agreement** controls in most situations. The RUPA governs other matters.
5. **Capitalization.** A general partnership cannot raise equity capital by selling shares. The partnership agreement should state the nature and amounts of initial and subsequent **contributions** by partners. It should also address whether **withdrawals** are restricted and individual partner capital, income, and drawing accounts are to be maintained.
6. **Profits, losses, distributions, and the partnership interest.** Unless otherwise agreed, each partner receives an equal share in profits and contributes in proportion to his/her share of the profits toward any **losses**. The **transferable interest** consists of a partner's share of profits and losses and the right to receive **distributions**. Partners may assign their interests without loss of the rights and duties of a partner. Moreover, the assignee does not become a partner in the firm without the consent of all partners.

7. **Rights.** The rights, duties, and powers of partners are largely defined by the law of **agency**. However, partners may agree to limit their rights. Each partner has rights to equal participation in management, access to partnership information, use or possession of partnership property (but not to own specific partnership property), **choice of associates**, and **an accounting**.
8. **Duties** of partners include the **fiduciary duties** of loyalty and care and the obligation of **good faith and fair dealing**.
9. **Powers** are governed by law and the partnership agreement. A partner has **apparent authority** to act as an agent, but a **statement of partnership authority** may give notice of limitations on authority.
10. **Liability.** A partnership is liable for loss caused by wrongful acts or omissions of any partner acting within the ordinary course of partnership business or with its authority. Also, each general partner has **joint and several liability**.
11. **Termination.** The process of ending a partnership may be governed by the partnership agreement. If it is not, the RUPA provides for dissociation, dissolution, winding up, and termination.
  - a. **Dissociation** (e.g., by death or express will to withdraw) is the legal effect of a partner's ceasing to be associated in carrying on the business. After dissociation, the business either continues after purchase of the dissociated partner's interest, or dissolution begins. The partnership is not necessarily dissolved by dissociation unless it occurs by express will.
  - b. **Dissolution** is the alternative to dissociation and continuation. Dissolution changes the relationships of the partners but is distinct from winding up. A partnership continues until winding up is complete. However, the partners may **unanimously agree to continue the business**.
  - c. **Winding up** is the administrative process of settling partnership affairs, including the use of partnership assets and any required contributions by partners to pay creditors. **Creditors** are paid in full before any distributions are made to partners.
    - 1) The priority rules for unsecured partnership creditors and individual partners' unsecured creditors are consistent with the **Bankruptcy Code**. Thus, unsecured partnership creditors have priority in partnership assets and share equally with creditors of partners in the partners' separate assets.
12. A **joint venture** is an association to accomplish a specific business purpose or objective. It has the advantage of ease of formation and is often organized for a single transaction. A joint venture is not a partnership because it does **not carry on a business**, but most rules governing general partnership apply, including those relating to formation.