

Types of Business Organization

It is important that the business owner seriously considers the different forms of business organization—types such as sole proprietorship, partnership, and corporation. Which organizational form is most appropriate can be influenced by tax issues, legal issues, financial concerns, and personal concerns. For the purpose of this overview, basic information is presented to establish a general impression of business organization.

Sole Proprietorship

A Sole Proprietorship consists of one individual doing business. Sole Proprietorships are the most numerous form of business organization in the United States, however they account for little in the way of aggregate business receipts.

Advantages

- Ease of formation and dissolution. Establishing a sole proprietorship can be as simple as printing up business cards or hanging a sign announcing the business. Taking work as a contract carpenter or freelance photographer, for example, can establish a sole proprietorship. Likewise, a sole proprietorship is equally easy to dissolve.
- Typically, there are low start-up costs and low operational overhead.
- Ownership of all profits.
- Sole Proprietorships are typically subject to fewer regulations.
- No corporate income taxes. Any income realized by a sole proprietorship is declared on the owner's individual income tax return.

Disadvantages

- Unlimited liability. Owners who organize their business as a sole proprietorship are personally responsible for the obligations of the business, including actions of any employee representing the business.
- Limited life. In most cases, if a business owner dies, the business dies as well.
- It may be difficult for an individual to raise capital. It's common for funding to be in the form of personal savings or personal loans.

The most daunting disadvantage of organizing as a sole proprietorship is the aspect of unlimited liability. An advantage of a sole proprietorship is filing taxes as an individual rather than paying corporate tax rates. Some hybrid forms of business organization may be employed to take advantage of limited liability and lower tax rates for those businesses that meet the requirements. These include S Corporations, and Limited Liability Companies (LLC's). Where S-Corps are a Federal Entity, LLC's are regulated by the various states. LLC's give the option for profits from the business to pass through to the owner's individual income tax return.

Partnership

A Partnership consists of two or more individuals in business together. Partnerships may be as small as mom and pop type operations, or as large as some of the big legal or accounting

firms that may have dozens of partners. There are different types of partnerships—general partnership, limited partnership, and limited liability partnership—the basic differences stemming around the degree of personal liability and management control.

Advantages

- Synergy. There is clear potential for the enhancement of value resulting from two or more individuals combining strengths.
- Partnerships are relatively easy to form, however, considerable thought should be put into developing a partnership agreement at the point of formation.
- Partnerships may be subject to fewer regulations than corporations.
- There is stronger potential of access to greater amounts of capital.
- No corporate income taxes. Partnerships declare income by filing a partnership income tax return. Yet the partnership pays no taxes when this partnership tax return is filed. Rather, the individual partners declare their pro-rata share of the net income of the partnership on their individual income tax returns and pay taxes at the individual income tax rate.

Disadvantages

- Unlimited liability. General partners are individually responsible for the obligations of the business, creating personal risk.
- Limited life. A partnership may end upon the withdrawal or death of a partner.
- There is a real possibility of disputes or conflicts between partners which could lead to dissolving the partnership. This scenario enforces the need of a partnership agreement.

As pointed out, unlimited liability exists for partnerships just as for sole proprietorships. One way to alleviate this risk is through Limited Liability Partnerships (LLP's). As with LLC's, LLP's may offer some tax advantages while providing some risk protection for owners.

Corporation

Corporations are probably the dominant form of business organization in the United States. Although fewer in number, corporations account for the lion's share of aggregate business receipts in the U.S. economy. A corporation is a legal entity doing business, and is distinct from the individuals within the entity. Public corporations are owned by shareholders who elect a board of directors to oversee primary responsibilities. Along with standard, for-profit corporations, there are charitable, not-for-profit corporations.

Advantages

- Unlimited commercial life. The corporation is an entity of its own and does not dissolve when ownership changes.
- Greater flexibility in raising capital through the sale of stock.
- Ease of transferring ownership by selling stock.
- Limited liability. This limited liability is probably the biggest advantage to organizing as a corporation. Individual owners in corporations have limits on their personal

liability. Even if a corporation is sued for billions of dollars, individual shareholder's liability is generally limited to the value of their own stock in the corporation.

Disadvantages

- Regulatory restrictions. Corporations are typically more closely monitored by governmental agencies, including federal, state, and local. Complying with regulations can be costly.
- Higher organizational and operational costs. Corporations have to file articles of incorporation with the appropriate state authorities. These legal and clerical expenses, along with other recurring operational expenses, can contribute to budgetary challenges.
- Double taxation. The possibility of double taxation arises when companies declare and pay taxes on the net income of the corporation, which they pay through their corporate income tax returns. If the corporation also pays out dividends to individual shareholders, those shareholders must declare that dividend income as personal income and pay taxes at the individual income tax rates. Thus, the possibility of double taxation.