# Business Management

Lecture 2

## Forms of Business Ownership


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# Forms of Business Ownership

- sole proprietorship
- partnership
- limited partnership
- limited liability company (LLC)
- corporation for profit
- nonprofit corporation , and
- cooperative.

# 1. Sole Proprietorships

The vast majority of small businesses start out as sole proprietorships.

These firms are owned by one person, usually the individual who has day-to-day responsibilities for running the business.

# 1. Sole Proprietorships

Sole proprietors own all the assets of the business and the profits generated by theme.

They also assume complete responsibility for any of its liabilities or debts.

In the eyes of the law and the public, you are one in the same with the business.

# Advantages and Disadvantages of a Sole Proprietorship

| Advantages |
|---|
| **To organize**, it is the Easiest and least expensive form of ownership. |
| **Sole proprietors** are in complete control, and within the parameters of the law, may make decisions as they see fit, receive all income generated by the business to keep or reinvest |
| **Profits from the business flow directly to the owner's personal tax return** |
| **To dissolve**, The business is easy, if desired |

# Advantages and Disadvantages of a Sole Proprietorship

| Disadvantages |
|---|
| Sole proprietors have <u>unlimited liability</u> and are <u>legally responsible</u> for all debts against the business.<br>their business and personal assets are at risk. |
| May be at a disadvantage in raising funds and are often <u>limited to using funds from personal savings or consumer loans</u> |

# Advantages and Disadvantages of a Sole Proprietorship

| Disadvantages |
| --- |
| May have a hard time attracting high-caliber employees or those that are motivated by the opportunity to own a part of the business |
| Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income) |

# 2. Partnerships

In a Partnership, two or more people share ownership of a single business.

Like proprietorships, the law does not distinguish between the business and its owners.

# 2. Partnerships

The partners should have a legal agreement that sets forth how ..

- decisions will be made,
- profits will be shared,
- disputes will be resolved,
- how future partners will be admitted to the partnership,

- how partners can be bought out,
- and what steps will be taken to dissolve the partnership when needed.

# Advantages and Disadvantages of Partnerships

| Advantages |
| --- |
| **Setup**: Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement |
| **Funds**: With more than one owner, the ability to raise funds may be increased |
| **The profits:** from the business flow directly through to the partners' personal tax returns |
| **Prospective employees:** may be attracted to the business if given the incentive to become a partner |
| **Skills**: The business usually will benefit from partners who have complementary skills. |

# Advantages and Disadvantages of Partnerships

| Disadvantages |
| --- |
| **Partners are jointly and individually liable** for the actions of the other partners. |
| **Profits** must be shared with others. |
| Since **decisions** are shared, disagreements can occur. |
| **Some employee benefits** are not deductible from business income on tax returns. |
| The partnership may have a limited life; **it may end upon** the withdrawal or **death of a partner**. |

# Types of Partnerships

1. General Partnership
2. Limited Partnership
3. Joint Venture

# Types of Partnerships

1. **General Partnership**

Partners divide responsibility for management and liability as well as the shares of profit or loss according to their internal agreement.

Equal shares are assumed unless there is a written agreement that states differently.

# Types of Partnerships that should be considered

2. **Limited Partnership** and Partnership with limited liability

Limited means that most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions, which generally encourages investors for short-term projects or for investing in capital assets.

This form of ownership is not often used for operating retail or service businesses.

# Types of Partnerships that should be considered

**3. Joint Venture**

Acts like a general partnership, but is <u>clearly for a limited period of time or a single project</u>.

If the partners in a joint venture repeat the activity, they will be recognized as an ongoing partnership and will have to file as such as well as distribute accumulated partnership assets upon dissolution of the entity.

# 3. Corporations

A corporation chartered by the state in which *it's headquartered is considered by law* to be a unique entity, separate and apart from those who own it.

A corporation *can be taxed*, it *can be sued*, and it *can enter into contractual agreements*.

# 3. Corporations

The <u>owners</u> of a corporation <u>are</u> its <u>shareholders</u>.

The <u>*shareholders elect a board of directors*</u> to oversee the major policies and decisions.

The corporation <u>*has a life of its own*</u> and <u>*does not dissolve when ownership changes*</u>.

# Advantages and Disadvantages of Corporations

| Advantages |
|---|
| **Shareholders** have limited liability for the corporation's debts or judgments against the corporations. |
| Generally, **shareholders** can only be held accountable for their investment in stock of the company.<br><br>(Note however, that officers can be held personally liable for their actions, such as the failure to withhold and pay employment taxes.) |
| **Corporations** can raise additional funds through the sale of stock. |
| **A corporation** may deduct the cost of benefits it provides to officers and employees. |
| Can **elects corporation status** if certain requirements are met. This election enables company to be taxed similar to a partnership. |

# Advantages and Disadvantages of Corporations

| Disadvantages |
|---|
| The process of **<u>incorporation</u>** requires **<u>more time</u>** and money than other forms of organization |
| Corporations are **<u>monitored by federal</u>**, state and some local agencies, and as a result may have more paperwork to comply with regulations |
| Incorporating may result in **<u>higher overall taxes</u>**.<br><br>**<u>Profits paid to shareholders</u>** are **<u>not deductible</u>** from business income; thus it can be taxed twice |

# 4. Limited Liability Company (LLC)

A limited liability company (LLC) *is a business entity created by statute*. It has some characteristics of a partnership and some others of a corporation.

LLC .. has the tax advantages of a partnership and the limited liability advantages of a corporation.

Properly structured, it is taxed as a partnership or an "S" corporation. If the LLC is not properly structured, it is taxed as a "C" corporation.

<table>
<tr><th>C Corp</th><th>S Corp</th></tr>
<tr><td>An organization formed under state or federal law. An artificial entity separate from its owners.</td><td>An organization structured like a corporation but taxed like a partnership.</td></tr>
<tr><td>File articles of incorporation and other required reports with the Secretary of State. Prepare bylaws and follow corporate formalities.</td><td>Must meet all criteria to file as an S corporation. Must file timely election with the IRS (within 21/2 months of first taxable year).</td></tr>
<tr><td colspan="2">Continues until formal dissolution. Most stable form of business. Not affected by death or disaffiliation of shareholder.</td></tr>
</table>

# 4. Limited Liability Company (LLC)

Forming a LLC is more complex than forming a partnership, but it is less complex than forming and operating a corporation.

<table>
<tr><th rowspan="2">Type of Business</th><th rowspan="2">Sole Proprietorship</th><th colspan="2">Partnerships</th><th colspan="2">Corporations</th><th rowspan="2">Limited Liability Company</th></tr>
<tr><th>General</th><th>Limited</th><th>C Corp</th><th>S Corp</th></tr>
<tr><td>Definition</td><td>A business owned and operated by one person for profit.</td><td>Two or more people who jointly own or operate a business for profit.</td><td>One or more partners have limited liability and no rights of management.</td><td>An organization formed under state or federal law. An artificial entity separate from its owners.</td><td>An organization structured like a corporation but taxed like a partnership.</td><td>A business entity created by statute. The owners are called members. It is taxed like a partnership or an s corp. It has limited liability like corporations.</td></tr>
<tr><td>Ease of Formation</td><td>Easiest form of business to set up. If necessary, acquire licenses and permits, register fictitious name, and obtain taxpayer identification.</td><td>Easy to set up and operate. A written partnership agreement is highly recommended. Must acquire an Employer ID number. If necessary, register fictitious name.</td><td>File a Certificate of Limited Partnership with the Secretary of State. Name must show that business is a limited partnership. Must have written agreement, and must keep certain records.</td><td>File articles of incorporation and other required reports with the Secretary of State. Prepare bylaws and follow corporate formalities.</td><td>Must meet all criteria to file as an S corporation. Must file timely election with the IRS (within 21/2 months of first taxable year).</td><td>File articles of organization with the Secretary of State. Adopt operating agreement, and file necessary reports with Secretary of State. The name must show it is limited liability company.</td></tr>
<tr><td>Period of Existence</td><td>Terminates at will or on the death of the owner.</td><td colspan="2">Terminates by agreement, or by death or withdrawal of partner, unless there is a partnership agreement to the contrary.</td><td colspan="2">Continues until formal dissolution. Most stable form of business. Not affected by death or disaffiliation of shareholder.</td><td>May terminate by agreement, or withdrawal of a member, depending upon operating agreement.</td></tr>
<tr><td>Taxes</td><td>Profits are taxed once. Profit and loss are reported on the owner's individual state and federal income tax returns.</td><td colspan="2">Profits are taxed once. Each partner reports his or her share of the profit and loss on his or her individual state and federal income tax returns. Partnership files an information return.</td><td>Profits are subject to double taxation, once at the corporate level, and again at the shareholder level.</td><td>Profits are taxed once. Each shareholder reports his or her share of profit and loss on individual income tax returns. S corp does not pay tax, with some exceptions.</td><td>If the LLC is structured properly, each member reports his or her share of the profit and loss on his or her individual income tax returns. It is taxed like a partnership or an S corp. If the LLC is not structured properly, it is taxed like a C corporation.</td></tr>
<tr><td>Liability</td><td>The owner's personal assets are at risk.</td><td>Each partner's personal assets are at risk.</td><td>General partners' personal assets are at risk. A limited partner is liable only to the extent of his or her investment.</td><td colspan="2">Limited to corporate assets, except:<br>1. Personally guaranteed business debts;<br>2. Personal negligence or fault; or<br>3. Corporate form is found to be a sham.</td><td>Similar to rules for corporations.</td></tr>
<tr><td rowspan="2">Dissolution</td><td rowspan="2">Easiest form of business to dissolve. Pay debts, taxes, and claims against business.</td><td rowspan="2">Pay debts, taxes, and claims against business. Settle partnership accounts.</td><td rowspan="2">Pay debts, taxes, and claims against business. Settle partnership accounts. File cancellation of certificate with the Secretary of State.</td><td colspan="2">Obtain shareholder approval to dissolve. File statement of intent to dissolve with the Secretary of State. Pay debts, taxes, and claims against business. Distribute corporate assets to shareholders.</td><td rowspan="2">Pay debts, taxes, and claims against business. Distribute remaining assets to members. File articles of dissolution with the Secretary of State.</td></tr>
<tr><td>Gain on distribution of assets is subject to double taxation.</td><td>Gain on distribution of assets is taxed once, with some exceptions.</td></tr>
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