Open Educational Resources Guttman Community College

2020

How to Choose the Right Business Organization Form

Anjelica Cappellino
CUNY Guttman Community College

Anjelica Cappellino
Business Law and Ethics

What to Consider When Choosing a Business Organization Form

- There are many different forms a business can take –
  - Sole Proprietorships,
  - Partnerships,
  - Limited Liability Organizations,
  - and Corporations

- Whatever business you enter will have a distinctive type of ownership. Although there are a variety of ways in which businesses may legally organize, the three most common forms of ownership are the **sole proprietorship, the partnership, and the corporation.**

- Many of you may decide to go into business. You may work for yourself or for others. You will need to select a business form that best fits your needs. Some of the factors you should consider in choosing a form are –
  - The number of owners
  - Tax considerations
  - The need to limit liability
  - Whether you plan to go public in the future
  - how ownership of the business will be transferred
  - whether you need to borrow a lot of money to operate the business;
  - the work and expense involved in setting up the business;
  - how management will be exercised; and
  - how continuity will be assured.

Sole Proprietorships

- Most businesses in the U.S. are owned and operated by individuals
- **Sole proprietorships** are owned and operated by one person
- There are no formalities required to establish a sole proprietorship. It is the most easily started of the three major types of business organization.
- Anyone who wants to start a business and has the money to do so may start a sole proprietorship. Any person starting a business must comply with all government rules and regulations that apply to businesses in general and to that person's business in particular.
  - This compliance may include obtaining a license for a certain type of business or profession, such as operating a taxi or practicing medicine.
- It will also usually include registering as a collector of state and local sales taxes.
- **Business Names -** In most states, a person using a business or trade name different from her or his own name must register that name, usually called a d/b/a form, in a public office. The owner of the business must also be identified, thereby enabling consumers to know with whom they may be dealing.
- **Management and Funding -** In a sole proprietorship, the owner has the full responsibility for managing the business. Generally, the owner supplies all the capital (money and other property) needed to start and operate the business, although additional money may be borrowed.

- The income from a sole proprietorship goes entirely to the owner, but so do the losses. The owner of a sole proprietorship receives no special tax advantages. Income the owner receives from the business is added to whatever income the owner may have from other sources; all the owner's income is taxed at the same rate. A sole proprietor who has no employees is not considered to be an employee and need not withhold taxes from his or her own distributions from the business but may be liable for self-employment taxes.
- **Advantages –**
    - The sole proprietorship is a very flexible form of business organization, allowing the owner to manage the business as he or she likes.
    - No special legal formalities are required to set up a sole proprietorship other than minor requirements such as purchasing a business permit or paying licensing fees.
- **Disadvantages –**
    - Many small-business owners go out of business every year, some of them because they do not have enough capital to continue to operate the business.
    - The risk of not being successful and losing all or most of the money invested in the business must be borne by the owner alone.
    - The owner, and only the owner, is liable for all the debts of the business.
    - The sole proprietorship ceases to exist when the owner dies or retires. The business may continue, often under the same name, but the ownership changes.

The Partnership

- A **partnership** is **an association of two or more persons to carry on as co-owners of a business for profit**
- The persons are known as **partners**
- The essential elements of a partnership are –
    - Sharing profits and losses
    - Joint ownership of partnership assets
    - Shared management
- Partnerships are for business and do not include joint ownership of properties (unrelated to businesses), hobbies, efforts of nonprofits, charitable organizations, or partnerships formed for recreational purposes
- **Partnership Name -** Like a sole proprietorship, partners using a business or trade name different from their own names must register the partnership name and their own names in a public office. Identification of the partners is required so that the public may know with whom they are dealing.
- Under the Uniform Partnership Act, a partnership is treated as a legal entity. It can buy, hold title to, and sell real estate in its own name. It can also make bank deposits and purchase securities. It is also treated as a legal entity for accounting purposes and in bankruptcy proceedings.
- In some states, a partnership may sue or be sued in its own name. The title of a suit brought by a partnership, for example, would be “John Doe and Richard Roe, doing business as Doe and Roe, a partnership,” and not “Doe and Roe.”
    - In other states, actions by or against a partnership must be brought in the names of the partners.

- A partnership is not a legal entity for **tax purposes**. There is no such thing as an income tax on partnerships.
    - The partnership acts like a funnel, pouring profits and losses into the hands of the partners.
    - The partners must include on their personal income tax returns their individual shares of the partnership profits and losses. Partnerships are required, nevertheless, to file informational returns for federal and state tax purposes.
- **Advantages –**
    - The ease of organization and dissolution, informality in management, and lack of a partnership income tax.
- **Disadvantages –**
    - The disadvantages are the unlimited liability of partners for partnership debts and torts, the difficulty of settling disputes among the partners, the difficulty in transferring a partnership interest, the lack of continuity, and the danger of dissolution if a partner withdraws or dies.

Limited Liability Company

- Limited partners cannot manage, else they lose their limited status. Sometimes, this creates problems for small businesses with a small number of partners
- The **limited liability company (LLC) was formed as a hybrid of a limited partnership and a corporation**
- It is taxed like a partnership, enabling investors to take advantage of losses and avoid double taxation of corporations
- But like a corporation, investors have limited liability. Their personal assets are not subject to judgments resulting from business lawsuits
- In a LLC (unlike LP), **all partners have limited liability**
- In a LLC (unlike LP), all members may participate in management
- **Forming a LLC (varies by state) –**
    - Draft the articles of organization that outline the LLC's purpose
    - File the articles with the department of state
    - Publish notice of the LLC formation
- Some states require at least two members; other states only need one member