Small Business 101

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Learn the advantages and disadvantages of the different types of business organizations.

Generally speaking, there are three types of business organizations: sole proprietorship, partnership, and corporation. Each has advantages and disadvantages, so read on to learn more about which type of business organization might work best for your business.

Sole Proprietorship

Many of us were sole proprietors at some point in our lives when we had a paper route or a babysitting job. You kept the money under your bed, paid your expenses, and what was left was your profit. While this is a very simplistic model of a sole proprietorship, the principles remain the same.

Let's look at a more adult version of sole proprietorship, "Sam Jones Machine Shop." The cost of formation and operation of the entity itself is relatively inexpensive. Running a machine shop is not cheap, but the legal fiction/entity is relatively cheap to form.

There are few legal requirements to create the entity. Typically these would include a business license, if needed, zoning approval, if needed, etc. The entity itself is very private and there are no public filings. The entity is taxed as an individual, not the double taxation treatment which one would typically see with a "C" Corporation (discussed further in this article).

In southwest Indiana, there are relatively few issues with a Sole Proprietorship conducting business in Illinois or Kentucky. There is no required filing with the Secretary of State with either of those states for a sole proprietorship.

Disadvantages

-The business itself ends with the death or incapacity of the proprietor. If Sam Jones were to die, the legal entity of "Sam Jones Machine Shop" dies. The assets (drills, lathes, etc.) of the sole proprietorship would flow according to Sam Jones's Will or in the case of no Will, the intestate succession plan of the state in which Mr. Jones died.

-Limited Personal Liability is often a concern for individuals starting a new business. Many individuals think they have to incorporate to avoid personal liability. This is somewhat of a street myth. In all likelihood, regardless of the legal entity, certain individuals will be subject to unlimited personal liability. This will be explained later in this article.

-With a Sole Proprietorship you must conduct business by yourself and you cannot use agents.

-The capital of the business is limited by the proprietor's own resources. You cannot sell stock in the entity because there is no stock. Your ability to borrow money will be limited by your personal resources.

-You are not an employee of your business. Consequently, some business deductions are not available to you.

-Finally, all profits are taxable income to you.

Typically, I advise clients starting out in a consulting role or a small business that it might be best for them to start out as a Sole Proprietorship. A Sole Proprietorship is easy, it is much cheaper to create, and I am a believer in walking before you run. I would rather see people take the money that would typically be used to incorporate and spend this money on liability insurance.

Partnership

A Partnership is basically two Sole Proprietorships joined together. The advantages of a partnership are:

1. Cost of formation and operation
2. Informality of operation
3. No double taxation

There is a contractual relationship between partners. In the event the partners do not write a Partnership Agreement, the Uniform Partnership Act, as ratified by the various states, governs the operation of the Partnership. Without a Partnership Agreement, typically the Partnership profits are divided 50/50.

Partnership formality is typically mid-way between a Sole Proprietorship and a Corporation. In a Partnership, there is no need for corporate minutes, corporate filings, etc. As a result of this informality, Partnerships are fairly private.

Partnerships can conduct business in other states fairly easily. There is no need for admission to do business in the various states as there would be with a Corporation.

It is easy to withdraw cash or property from a partnership, provided there is cash or property to withdraw and there is agreement among the partners. The earnings of the Partnership would be taxed to the individual partners via what is called a K-1 showing the partner's earnings from the Partnership.

Disadvantages

-As a legal entity, the Partnership dissolves upon the death or incapacity of a partner. "Smith and Jones" ceases as a legal entity if Smith were to die.

-There is unlimited personal liability of the partners for the obligations of the business. If your partner buys assets in the name of the Partnership, creating debt, you could be held personally responsible for those debts in the event your partner and/or Partnership did not pay. Likewise, if a partner were to commit malpractice, you could be held responsible for the other partner's malpractice.

-All partners have equal rights, unless provided for differently in a Partnership Agreement. It is not unusual where one partner comes in with money and one partner comes in with the brains, business expertise, or contacts. A provision can be made to provide the non-monetary partner to have a smaller share of the profits or larger share as the case may be. However, it must be set out in the Partnership Agreement to differentiate.

-It is difficult to transfer interests within a Partnership. If there are three partners in a Partnership, the only way one of the three can pull out of the Partnership and sell their interest in the Partnership to a fourth party, would be by agreement of the other two partners.

-It is difficult to raise capital within the Partnership because the Partnership is bound by the personal resources of each of the partners.

-A Limited Liability Partnership is a Partnership with a difference. In a Limited Liability Partnership, each of the partners' liability for acts of the Partnership can be limited.

Corporation

Corporations come in three types: "C" Corporation, "S" Corporation, and Limited Liability Corporation.

"C" Corporation

"C" Corporations are typically large Corporations with many shareholders, such as Alcoa or Whirlpool. The advantage of these Corporations is that there is a continuity of existence. If a shareholder of Alcoa were to die, Alcoa keeps running. The stock the deceased shareholder may have in the Corporation is transferred by Will or intestate succession.

“S” Corporation

An “S” Corporation, on the other hand, is typically a very small Corporation limited to 75 shareholders. An “S” Corporation derives its name from Subchapter “S” of the Internal Revenue Corporate Code. It has to do with tax treatment.

A “S” Corporation does not have the double taxation of a “C” Corporation. For example, if Alcoa were to make $100 and assuming it has one shareholder, the $100 is taxed at the Corporate rate to Alcoa (assuming 25%) leaving the distribution to the shareholder of $75. The $75, in turn, is taxed at the individual shareholder’s rate (assuming 33%) leaving a net distribution to the shareholder of $50.

On the other hand, if an “S” Corporation were to make $100, and have only one shareholder, the entire $100 passes through to the tax return of the individual shareholder. The individual shareholder is taxed on the $100 (assuming 33% tax rate). The net to the individual shareholder will be $66.66, a savings of $16.66 versus the double taxation of the “C” Corporation.

Limited Liability Corporation

A Limited Liability Corporation is a hybrid that was created in Indiana in the early 1990s. The Limited Liability Corporation was created to answer some of the deficiencies of the “S” Corporation. An “S” Corporation allowed only one type of shareholder. The Limited Liability Corporation however, can have different classes of shareholders. A Limited Liability Corporation can provide for a Corporation to be a shareholder together with individuals.

The big question confronting many individuals is whether to choose to form a Limited Liability Corporation or an “S” Corporation. For the most part, the “S” Corporation has now been modified such that it is very similar to a Limited Liability Corporation.

Advantages of Corporations

Turning back to Corporations in general, Corporations typically have centralized management. It is easy to transfer ownership. The Corporation is a legal entity apart from the shareholders. The shareholders can occasionally borrow on the strength of their interest in the enterprise. Shares are typically more acceptable as collateral than one’s interest in a Partnership. I can pledge my 100 shares of Alcoa stock as collateral for a loan much more easily than I could pledge my one-fourth interest in my law firm.

Other advantages of a Corporation are the fringe benefits being available to corporate employees typically without the tax implications that may arise in a Sole Proprietorship or a Partnership.

In a Corporation, the entity has the ability to award a security interest in the enterprise to attract or retain key employees. The Corporation can grant shares of stock to a key employee as a reward/bonus or retention device.

Disadvantages

The idea of limited liability of the shareholders for obligations of the Corporation is somewhat of a myth depending upon the type of Corporation. With a “C” Corporation, such as Alcoa, if Alcoa were to have a horrendous accident causing catastrophic injuries or damages, the liability of the individual shareholders would be the value of the stock they have in the Corporation. If I owned one share of stock and the stock were valued at $25, my risk in this catastrophic event would be the value of my one share ($25).

The myth part of the limited liability concept comes about when dealing with smaller Corporations, be it a Limited Liability Corporation or “S” Corporation or a very small “C” Corporation. For example, if I were to create a Corporation, Tim Hambidge Rental Homes, Inc., in all likelihood because of size and finances, I am probably going to be the maintenance person for the Corporation. If, in that capacity, I repair a door step and have done a negligent job, in all likelihood the first person named in the lawsuit would be Tim Hambidge Rental Homes, Inc. The second name on the lawsuit more than likely will be Tim Hambidge, individually, because I was the one wielding the hammer and did the negligent job fixing the door step.

Likewise, if I were to borrow money in the name of the Corporation, in all likelihood the lending institution would require a personal guarantee from me on the money. Alcoa, on the other hand can borrow money pledging the value of its assets. Small Corporations can obtain loans but the banks inevitably are going to require a personal guarantee.

-Formation of a Corporation is somewhat time-consuming, formal, and more expensive to operate. A Corporation needs to file Articles of Incorporation with the Indiana Secretary of State, write bylaws, issue stock, create a corporate book and do yearly corporate meetings with formal minutes.

-Corporations are more open to public scrutiny in that you have to share more information with the public. The Agent of Service and the names of the incorporators are known. As you become more formal, you become more transparent.

-Another restriction on a Corporation is it cannot do business across state lines without first being admitted to do business by the affected states’ Secretary of State. The Corporation must seek admittance in the various states in which it wants to do business other than its home state.

-Due to the limited liability of the shareholders, there may be a limit on the credit that is available to a Corporation unless the shareholders are willing to personally guarantee corporate obligations. The Corporation can obtain loans, but typically the lending institution is going to require personal guarantees of those obligations if the Corporation does not have sufficient assets to put forth as collateral.

-A minority shareholder holding less than 50 percent of the shares is always going to be at a disadvantage to those shareholders holding 51 percent. As a minority shareholder, you are always going to have the business dictated to you within certain bounds by the majority shareholders.

Questions that need to be analyzed when thinking about what type of business entity are as follows:

1. Are you interested in the simplest and least expensive form of business entity to form and maintain, or are there other overriding concerns?
2. Do you have sufficient cash to conduct the business on your own or do you need others to invest in the business?
3. Do you want co-owners to have an equal voice in the management and day-to-day operation of the business? Who would be the final decision maker?
4. How much capital do you need to raise to operate the business and do you want these investors to control the business or just share the profits and the losses?
5. Given the nature of the business enterprise, how important is it to limit the personal liability of the investors for the debts and obligations of the business? Can this potential liability to third parties be covered by insurance?
6. How burdensome would it be for you to comply with the complexities and expenses associated with the corporate or limited partnership business forum?
7. Are you willing to provide an unlimited personal guarantee for the debts and obligations of the corporation to a bank or other creditor?
8. Do you want investors to be able to transfer their ownership interest freely or should transfers be subject to restrictions? If so, what restrictions?
9. Do you want the business to continue notwithstanding the death or retirement of an owner?