Forms of Organization- Additional Reading

A house should be built on a strong foundation so that it will last for years to come. If the foundation is weak, the house may fall down. If the foundation is solid, the house will not only last for years, but you can add rooms onto that house over time as your goals change.

The same thing goes for a business – it needs a solid foundation that allows it to survive and possibly grow to meet future needs. That foundation is called the “form of organization” or “form of ownership”. There are 6 primary forms of business organization that allow businesses to survive and grow over time:

- Sole Proprietorship
- General Partnership
- Limited Partnership
- C-corporation
- S-corporation
- Limited Liability Company (LLC)

Now for the big question, “which is the best form of organization for my business?” The answer is, “it depends on three main factors.” Those three factors are:

- Ease of transfer of ownership to others
- Taxation of the business’ profits
- Liability (risk) that the business faces.

Ease of transfer of ownership is important for businesses that want to continue into the future. Many family businesses are passed from one generation to the next. With certain forms of organization this transfer is complicated; with others it is very easy. The three main methods of transferring the ownership of a business from one person to another are:

- Purchasing the business from the current owner
    - You may purchase the entire business or a percentage of the business
- Giving the ownership of the business to others as a gift
- Inheriting the ownership of the business at the death of the current owner.

Each of these methods can be effective, but they will have different tax implications. More importantly, some of these methods of transferring the ownership of a business are much easier than others. We will talk about these differences later. Let’s look at Greta’s Green Grocery for a minute. If she only wants to operate the business for the next 5 years and then close it down, she will not have to be concerned with the ease of transfer – she’ll simply sell the assets. But, what if Greta wants to pass the business to her niece, Emily? Now she must think about which form of organization will allow her to transfer the business to Emily in the easiest, most effective manner.

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Most people do not like to pay income taxes, although if you think about it, you only pay income taxes when you make money! So paying income taxes is not a bad thing. But you don't want to have to pay more than you have to. Most forms of business organization are taxed at the owner's personal income tax rate. This is called "pass-through taxation" – the profits literally "pass through" to the owner's personal income tax statement. The other forms of ownership are taxed at the "corporate income tax rate" – in most cases the corporate income tax rates are higher than the personal income tax rate. One major concern that business owners have is something called "double taxation". This is a situation where some of the profits of the corporation are taxed at both the corporate tax rate and the owner's personal tax rate.

The last main factor in choosing a form of organization is liability. Liability is a term that means you are responsible for any of your actions that might harm others. Some forms of organization have "unlimited liability". Unlimited liability means that the business assets AND the personal assets of the owner (houses, cars, etc.) may be sold to pay for any damages caused by the owner's business. In the case of a major lawsuit, the owner may have to sell all of the business assets, and then have to sell some of his/her personal assets to come up with enough cash to pay the damages. Some forms of organization provide "limited liability". This means that only the business assets can be used to pay the damages – but the owner's personal assets do not have to be sold to pay damages. In Greta's case, this would mean that she might have to sell the business assets (freezers, refrigerators, etc.), but not her house and car. But please understand that the forms of organization that offer limited liability do not always protect your personal assets – that's why every business needs liability insurance.

Now, let's describe the main forms of organization.

Sole Proprietorship

A sole proprietorship is owned and managed by one person. There may be several employees, but that one person owns all of the business' assets and makes all of the business decisions. The owner has full control of the business and gets all of the profits of the business. However, the owner also faces all of the risk (liability) associated with the business – he/she has unlimited liability, which means his/her personal assets are at risk because of the business.

This is the easiest form of organization to start. All you have to do is give your business a name, purchase any required business licenses or permits, and open the doors to your business. There is very little cost to start a sole proprietorship. Easy and low start-up costs – these are the two reasons that over 70% of the businesses in the US are sole proprietorships. Another reason is that the earnings of the business are taxed at the owner's personal income tax rate (which is usually lower than the corporate income tax rates).

The main disadvantages of a sole proprietorship are that it has unlimited liability, it is hard to transfer the business to someone else, and it is harder to get access to resources (such as loans). Transferring ownership of a sole proprietorship requires that you dissolve the sole proprietorship

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(end its life). If the owner wants to bring in a business partner, he/she has to change from a sole proprietorship to a partnership or a type of corporation – that's because a sole proprietorship is owned by one person, no more than that. The last disadvantage is that it is harder to get access to resources because there is only one owner. If there were 2 or 3 owners, now you can "pool" their assets together, but you can't do that with just one person.

Partnerships

Partnerships are very similar to sole proprietorships, except that there is more than one owner. These are very simple to start, they have low start-up costs, they have unlimited liability, and the profits are taxed at the owners' personal tax rates – just like sole proprietorships. Also, it is relatively difficult to transfer the ownership to people other than the existing owners – if you want to add new partners you may have to dissolve the existing partnership and start over.

The main difference is that there is more than one owner, and that means there can be more than one person making the decisions for the business. This can lead to arguments between the owners.

There are a couple of other things to know about partnerships. First, because there are two or more owners, they can pool their resources rather than relying on just one person's resources. This makes it easier to have a larger business than with a sole proprietor. The second thing is that each partner is responsible for the other partner's actions. This means that if your business partner makes a mistake, you are personally responsible for the damages. For example, assume that Greta and Emily form a partnership. One day, Emily doesn't properly store the produce. That afternoon, some of the customers get sick from eating this produce – they decide to sue the entire business to cover their medical costs. In this case, Greta's personal assets may have to be sold to pay the damages, even though it was Emily's mistake!

There are two main types of partnerships – General Partnerships and Limited Partnerships. A General Partnership is what we've described already – more than one person, unlimited liability, and so on. In a Limited Partnership, at least one partner is a "limited partner" or a "silent partner". Silent partners simply contribute resources to the business – such as money, land, equipment – but they have absolutely no voice in the management decisions. So they actually are "silent" when it comes to the management of the business. Silent partners have limited liability – the only thing they can lose in a liability lawsuit or bankruptcy is the value of the resources they contributed to the business. For example, let's assume that Greta's uncle, Greg, is a silent partner in the grocery. Greg contributed the land and building to the business. In the event of a lawsuit, the only things that Greg might lose are the land and the building. No one can force Greg to sell his personal assets to cover the damages. But Greta and Emily, who are not silent partners, may lose some of their personal assets. Please note that a silent partner can never make any management decisions for the partnership. If he/she does make some management decisions, he/she is no longer a silent partner and his/her personal assets are now at risk.

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Corporations

Corporations are more formal than sole proprietorships and partnerships. You typically need legal help in establishing a corporation – that means you have to hire a lawyer, and that costs money. To establish a corporation you need to have corporate by-laws (rules of operating the business) and articles of incorporation (legal documents describing the business) that are filed with the State Corporation Commission. So forming a corporation is harder and more expensive than forming a sole proprietorship or partnership.

Corporations have an "unlimited lifetime" – that means that they continue to exist even when some of the owners die or leave the business. This is not true for sole proprietorships or partnerships. All you need to do to be an owner of a corporation is own "shares" of the corporation's "stock". One stock is equivalent to one share of the ownership of the corporation. If you want to be an owner of John Deere, all you have to do is purchase one of more shares of the John Deere stock - it's that simple! And once you own stock you can sell it, give it away, or you can leave it to your heirs as an inheritance. This makes it very easy to transfer the ownership of a corporation to other owners. If Greta formed her store as a corporation, she can make Emily a co-owner by giving her some shares or selling her some shares. Greta can even leave the remaining shares of her stock in the business to Emily in her will. One of the main reasons owners choose to form a corporation is that it is every easy to transfer the ownership.

Another reason that owners like to form their business as a corporation is that it provides limited liability to the owners (shareholders). In most cases, a shareholder of a corporation can only lose the value of his/her investment in the stock of the corporation. For example, assume that you own $1,000 of stock in John Deere. If John Deere were to be sued or go bankrupt, the maximum that you would lose is your $1,000 of stock – no one can come after your personal assets. However, do NOT rely on this to protect your personal assets – every business owner needs liability insurance to fully protect his/her personal assets.

Corporations also allow owners to gain access to more resources than sole proprietorships and partnerships. If a corporation wants to generate more cash so that they can buy new equipment, they can simply sell more shares of the company. This raises cash that can be used for expanding the business or paying off loans.

Taxation of corporations is different than for sole proprietorships and partnerships. For most corporations, the earnings of the company are taxed at the corporate tax rate, which is usually higher than the personal tax rate. Further, if the corporation decides to pay some of the after-tax profits to its shareholders as a reward for investing in the company, these "dividend" payments are taxed again at the personal tax rate. This is called "double taxation".

There are two main types of corporations for most business owners: C-corporations and S-corporations. A C-corporation is a business that has no limits on who can be an owner. The profits of a C-corporation are taxed at the corporate tax rate. An S-corporation has limitations on how

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many people can be an owner of the business (no more than 75). S-corporations are used by many family-owned businesses so that they can keep the ownership of the company to members of the family. Hence, S-corporations are sometimes called "closely-held corporations" because the ownership is held within the family. The profits of an S-corporation are taxed at the owner's personal tax rate. Regardless of which type of corporation you choose, you can form a corporation with as little as one owner.

Limited Liability Companies (LLC)

Limited Liability Companies (LLCs) are a combination between corporations and partnerships. As the name states, LLCs offer the owners a form of limited liability (to protect their personal assets). This protection is limited to the value of their ownership in the business. Where owners of a corporation are called shareholders, the owners of an LLC are called "members" – but in reality there is not much difference between shareholders and members.

LLCs are very flexible. Owners can structure an LLC so that it looks and acts like a C-corporation, or like an S-corporation, or like a partnership or sole proprietorship. Most LLCs are set up so the profits are taxed at the owner's personal tax rate. This allows the owner(s) to avoid double taxation.

To be honest with you, there is not a very big difference between a C-corporation, an S-corporation, and an LLC for most small businesses. They each provide limited liability, have an unlimited lifetime, and can easily be transferred to other owners. The primary difference between these three forms of business is the method in which the profits are taxed.

Please see the following table for a side-by-side comparison of the main forms of business organization.

What about Greta? Which form is best for her green grocery? The answer to that depends on her goals. Here's a brief look at her decision:

If she only wants to operate the business on her own for a few years and has no interest in transferring the ownership to someone else:

A sole proprietorship might be a good choice. It is easy to set up, it doesn't cost much money to set-up, and she is in complete control of the business. The main disadvantage is that she will face unlimited liability – that means her personal assets are at risk. But she can reduce that risk by having liability insurance.

She could form a corporation (C or S) or an LLC in this case. This would be more costly, but might provide a little more liability protection. It also makes it easier to transfer ownership if she changes her mind in the future.

If she wants to operate the business with Emily as a co-owner and manager:

Because there is more than one owner, we can rule out a sole proprietorship. If both Greta and Emily are making management decisions they cannot be "silent partners" – so that rules out a

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limited partnership. But any of the remaining forms would be appropriate. The general partnership would be the easiest and lowest cost organization to set up; however, it would have unlimited liability and it would be relatively difficult to bring in other partners.

They could form a corporation (C or S) or an LLC in this case as well. This would be more costly, but might provide a little more liability protection. It also makes it easier to bring in new owners in the future. It also makes it much easier for Greta to turn the entire business over to Emily when Greta decides she wants to retire – she can either sell her shares in the business to Emily, or gift them to her.

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