

Module Six

Types of Business Organizations



Although there are many ways in which businesses may be formed, they commonly fall into one of the following categories:

- Sole proprietorships
- General partnerships
- Corporations
- Limited liability companies
- Limited liability partnerships

Costs of doing business and potential liability should be the foremost considerations when one is choosing the appropriate business form.

Costs include costs of formation (start-up costs), ongoing expenses, and taxes. Consideration of liability of business owners is of vital importance. For example, if a business owner is sued, he or she must be aware of the impact this would have not only on the business but also on the owner's personal assets. Other considerations include the ease of doing business, ease of expansion, and whether the business will own property. It is with those issues in mind that one must determine the appropriate business form. Below is a brief discussion of these issues as they relate to the most common business forms.

The most basic of business forms is the sole proprietorship. **Sole proprietorships** are businesses owned by one person. Forming a sole proprietorship is easy and inexpensive. In most instances, it simply involves finding a space (if necessary) and "hanging a shingle." The owner of the sole proprietorship and the business itself are one and the same. The business is not a legal entity that is separate and distinct from the owner. Most states do not require sole proprietors to submit any formal filings in order to start or maintain the business. Therefore, this type of business is not subject to expenditures associated with other business forms (e.g., articles of organization, and annual reports). Because the business is not a separate legal entity, the business is not taxed. Instead, the owner is taxed on any profits derived from the business. The income from the business and any taxes thereon are

passed through to the business owner. This pass-through taxation avoids the double taxation to which corporations are subject. However, a sole proprietor is personally liable for any debts, contracts, or tort actions. This exposes the owner to substantial risk of losing personal assets should the business be sued.

General partnerships are similar to sole proprietorships but involve more than one owner. The benefits and disadvantages are the same for general partnerships as they are for sole proprietorships. However, there is one additional risk in that each partner is personally liable for the acts of the other partners. There is another category of business that resembles a partnership but lacks the formal documents. In such instances, individuals or businesses agree to work together on a project or business in some capacity. In such cases, the court may find that such enterprises constitute a joint venture, which has distinct legal rights and responsibilities regarding duties, profit sharing, and liabilities.

Corporations are more complex than sole proprietorships and general partnerships. Corporations are legal fiction. As such, they are treated like people. They can sue and be sued and can even be criminally prosecuted. Because of the complexities involved in forming and operating corporations, it is usually necessary to utilize the services of an attorney and an accountant. Corporations are owned by one or more shareholders. Shareholders are those people (or entities) who buy stock in the corporation. In order to form a corporation, the organizers are required to file articles of organization (also known as articles of incorporation) with the appropriate state agency. The articles will state the number of shares issued and the owners of those shares. The articles also include a statement describing the purpose of the business. A corporation must also adopt bylaws. Further, corporations are required to file annual reports with the appropriate state agency and to hold annual meetings. At the commencement of the corporation and each year thereafter, directors and officers are elected. Directors are responsible for hiring officers and for major changes to the corporation. Officers are responsible for the day-to-day operation of the corporation. Directors, officers, and shareholders are usually one and the same in small, privately held corporations. In any event, the corporate formalities can become quite costly. Additionally, unlike sole proprietorships and general partnerships, corporations do not enjoy pass-through taxation (with one exception, which is described below). The corporation itself is taxed on any profits, and thereafter individual shareholders are taxed on any dividends. This is known as double taxation.

The main benefit of a corporation is that it limits the liability of officers, directors, and shareholders up to the amount of money invested in the corporation. Therefore, a corporation helps protect personal assets. In order to maintain this protection, corporations must adhere to the corporate formalities. For example, personal and corporate monies should never be commingled. Failure to adhere to corporate formalities could lead a court to

“pierce the corporate veil.” This occurs when a corporation is sued and the court finds that the corporation was not operated properly or was simply a sham to provide protection. If the corporate veil is pierced, owners, directors, and officers are subject to personal liability.

One type of corporation is particularly advantageous to small businesses. This is known as an S corporation. **S corporations** enjoy the protections afforded by other corporations but have the added advantage of pass-through taxation. The formation and other formalities of a corporation are required. However, after forming the corporation, it can elect to be designated as an S corporation by filing a form with the Internal Revenue Service. In order to be approved as an S corporation, the organization must have a limited number of shareholders, be privately held, and include no foreign investors. Other requirements of becoming an S corporation can be found in the textbook and on the [Small Business Association website](#).

A **limited liability partnership (LLP)** is similar to a general partnership, except that an LLP shields partners from personal liability up to his or her investment in the partnership. Partners enjoy the benefit of pass-through taxation.

A **limited liability company (LLC)** is similar to an LLP but requires certain formalities, including filing documents with the appropriate state agency. It shields owners (also known as managers) from personal liability. One major benefit to the LLC is that it allows for passive income without the tax liability imposed on corporations (or even S corporations). If a business wishes to own property or collect passive income, an LLC is a sound choice.