What Kinds of Businesses Are Best Organized as Sole Proprietorships?

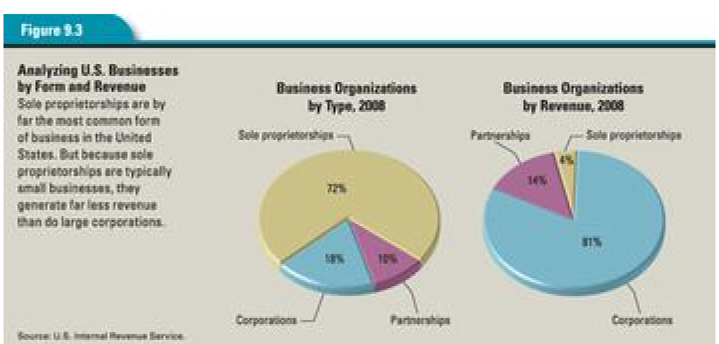
Businesses come in all shapes and sizes, ranging from small home-based businesses to huge companies with offices around the world. Economists categorize businesses based on how they are organized. Most U.S. business organizations fall into one of three general categories: sole proprietorships, partnerships, or corporations. The most common is the **sole proprietorship**, a business owned and managed by one person.

Sole Proprietorships: One Owner, One Operator

In a sole proprietorship, the owner of the business—the proprietor—earns all the profits and is responsible for all the debts. This form of business can be simple to establish and easy to manage, with relatively low start-up costs.

This is the kind of business Timothy Redel chose when he started his photography business. Redel had traveled all over the world working as an assistant for other photographers before he went into business as a sole proprietor. To do so, he borrowed $10,000 from a bank. With these funds, he bought cameras and lighting equipment and set up shop, using his small apartment as a studio. He went on to become a highly successful photographer whose work has appeared in many national magazines.

The ease of starting a sole proprietorship is probably why about 7 out of 10 businesses are organized this way. It is a form of business that appeals to people who have a marketable skill or trade and want to work for themselves rather than a boss. A sole proprietor might be a plumber, a pet sitter, a caterer, a farmer, a consultant, or an artist like Redel.



Advantages of Sole Proprietorships

For anyone thinking of starting a business, the sole proprietorship offers a number of advantages.

Ease of start-up. There is little paperwork involved in starting a sole proprietorship. Though requirements vary by city and state, the basics include

• obtaining a **business license** or **business permit**, a legal document that allows a business to operate in that state, city, or town.

• obtaining any necessary **zoning permits**. Local governments often designate certain areas, or zones, for specific business purposes.

• registering the **business name**. If a business carries the owner's legal name—as in Timothy Redel Photography—this step is not necessary. If not, the proprietor must submit a "doing business as" form to the local government office.

Few restrictions. Sole proprietorships are the least regulated form of business. However, some regulations do apply to specific industries. For example, any business that serves food is subject to health department regulations.

Full decision-making power. A sole proprietor makes all business decisions without having to consult with partners or shareholders. The freedom to make decisions quickly in response to market changes can be a great advantage for a business owner.

Full profits and individual taxation. A sole proprietor keeps all the profits generated by the business after paying taxes. Sole proprietors pay personal income tax on their earnings. The business itself pays no taxes.

Ease of closing. Sole proprietors can dissolve their businesses easily if they choose to do so. However, they must pay off business debts and taxes.

Disadvantages of Sole Proprietorships

Sole proprietorships also have disadvantages. Below are the three main drawbacks of this form of business.

Unlimited liability. The legal obligation to pay debts is known as **liability**. Sole proprietors have **unlimited liability**, or full

Key Concept

Sole Proprietorship

A sole proprietorship is a business owned and operated by one person. The owner keeps the profits, if any, and is liable for debts.

- Advantages include ease of opening, few regulations, and decision-making control by the owner.
- Disadvantages include modest growth potential and a limited business life.

responsibility for paying any debts their businesses take on. If a business does not have enough assets to repay its debts, the owner must use his or her personal assets—such as a home, car, or bank account—to do so. Unlimited liability is the tradeoff a sole proprietor makes for having complete control and reaping all the profits.

Many sole proprietors reduce their liability by organizing their business as a **limited liability company**. As in a sole proprietorship, the proprietor of an LLC pays personal income tax on the business's profits. But the proprietor's liability is limited to whatever he or she has invested in the company. This feature of LLCs has made them increasingly popular with business owners in recent years.

Limited growth potential. Because the success of a sole proprietorship rests on just one person—often a novice entrepreneur with limited assets—investors may be reluctant to lend money to a sole proprietor. Sole proprietorships can thus have difficulty obtaining the capital needed to expand.Business growth often depends on profits that can be reinvested in the enterprise.

Limited life. A sole proprietorship almost always ceases to operate if the owner dies, goes bankrupt, or is unable to run the business for any reason. New management does not usually take over this type of business. This lack of permanence may discourage some people from seeking work in a sole proprietorship. It may also make lenders reluctant to make loans to businesses with a single owner.

What Kinds of Businesses Are Organized as Partnerships?

In 1988, brothers Wing Lam Lee , Ed Lee, and Mingo Lee decided to go into the restaurant business together. The brothers were surfers who had grown up in Brazil, had surfed in Mexico, and had worked in their family's Chinese restaurant. All of these influences came together in their first restaurant: Wahoo's Fish Taco in Costa Mesa, California. Wahoo's featured a Mexican-Brazilian-Asian menu with grilled fish tacos as the specialty. The restaurant was so successful that by 2013, the partners had opened more than 60 Wahoo's.

Partnerships like that of the Lee brothers are well known in the business world. Ben Cohen and Jerry Greenfield, friends since middle school, founded Ben & Jerry's.Google, the Internet search company, was founded by partners Larry Page and Sergey Brin. Partnerships are the second most common form of business organization in the United States.

Partnerships: Multiple Owners, Shared Profits

A **partnership** is a business owned by two or more co-owners. Partners share profits from the business. They also share liability for any debts the business incurs. Family-owned businesses, small stores, farms, and medical practices are common examples of business partnerships. Law firms, accounting firms, and money-management firms also frequently form partnership agreements.

Partnerships may be formed by an oral agreement. However, the more common practice is to draw up a legally binding written agreement. There are different kinds of partnerships, each of which confers different responsibilities on the partners. The following are the three most common kinds of business partnerships:

General partnership. A **general partnership** is a form of business in which all co-owners have unlimited liability for any business debts. The owners, or **general partners**, are also active in the operations of the business.

Limited partnership. A **limited partnership** has at least one general partner and one or more limited partners. The **limited partners** contribute financial capital but leave day-to-day business operations to the general partners. For this reason, limited partners are also known as **silent partners**.

The main advantage of being a limited partner is **limited liability** for debts owed by the partnership. Limited partners can lose only the amount of money they invested in the business should it be sued or go bankrupt.

"It seems pretty easy to make partner here."

Limited liability partnership. In a **limited liability partnership**, co-owners are allowed to operate like general partners while enjoying the protection of limited liability. An LLP is well suited to businesses in which all partners want to take an active role in managing the business. Professionals, such as attorneys, doctors, dentists, and accountants, often form LLPs.

Advantages of Partnerships

Like sole proprietorships, partnerships offer entrepreneurs a number of advantages.

Ease of start-up. Partnerships are relatively easy to establish. The same business permits that are required for a sole proprietorship are also required for a partnership. In addition, business and legal experts recommend that a legal agreement, known as **articles of partnership**, be drawn up. Articles of partnership usually specify

• each partner's contribution in assets and labor.

• each partner's share of the profits and losses.

• each partner's authority and duties.

• how partners will settle disagreements.

• what happens in the event that a partner dies or leaves.

• how assets will be divided if the business fails.

If articles of partnership are not drawn up, most states have guidelines regarding partner rights and responsibilities that automatically go into effect.

Few restrictions. Partnerships are subject to few government regulations. However, like sole proprietorships, they must meet industry-specific regulations, such as health codes.

Shared decision-making power. "Two heads are better than one" is the philosophy guiding most partnerships. Partners can pool their experience and skills in making the decisions that guide the business.

Specialization. Partners often bring different areas of expertise to a business. For instance, one partner may be good at managing people, whereas another may be a marketing whiz. Partnerships allow partners to do what each does best for the company's overall benefit.

Individual taxation. Partners share in the profits according to whatever arrangement they have made.Each partner pays income taxes on his or her share. The business itself does not have to pay taxes.

Increased growth potential. People who go into business together each bring financial assets to the enterprise—their own assets as well as those of family and friends. Banks therefore see less risk in lending money to a partnership than to a sole proprietorship, which draws on the assets of just one person. For the same reason, suppliers are more willing to extend credit to a partnership.

With greater access to capital, partnerships often find it easier to expand their operations than do sole proprietorships. They are also better able to attract and hire talented employees, some of whom may aspire to become partners themselves someday.

Disadvantages of Partnerships

Partnerships also have drawbacks.

Unlimited liability for general partners. Unless a partnership is a LLP, at least one partner—the general partner—has unlimited liability for debts. Should the business run into financial problems, general partners stand to lose not only what they have invested but also their personal assets outside the business.

Conflict between partners. Like any relationship, a business partnership has the potential for conflict. Partners who see eye to eye when they first go into business may come to disagree about management style, work habits, ethics, or the firm's general goals and direction. Partnership agreements do not address such issues.Good communication and an honest effort to resolve conflicts are essential if a partnership is to survive.

Continuity issues. Partnerships are a temporary form of business. If one partner dies or decides to leave a partnership, the remaining partners will need to buy out the former partner's share. The value of this share may be difficult or impossible to determine. Moreover, the remaining partners may not have the liquid assets needed to buy it. Survival may depend on finding a new partner with the financial resources to purchase the outgoing partner's share of the business.

5. Why Are Large Businesses Organized as Corporations?

Sometimes sole proprietors or partners realize that they need more financial capital to grow their businesses than they can provide on their own. One way to raise these funds is to seek venture capital. **Venture capital** is money from an individual investor or organization that invests in promising new businesses in exchange for a share of ownership. Another common way to raise money is to sell shares

in the company to the public on the stock market. In either case, this is the time for the company to be reorganized as a corporation.

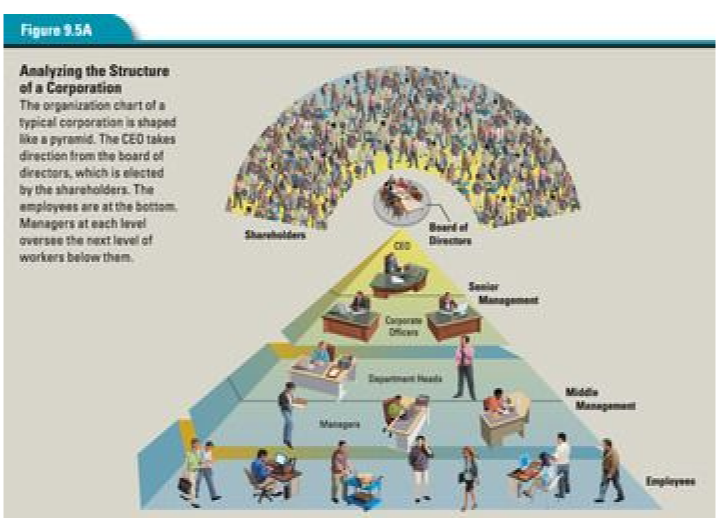
Corporations: Ownership by Shareholders

The word *corporation* has its roots in the Latin word corpus, which means "body." The root of the word reflects the modern legal definition of **corporation**: a company treated under the law as a single body with its own powers, separate from its owners. A corporation can enter into a contract. It can buy and sell property, just as an individual can.

Corporations are owned by shareholders who purchase shares of company stock. When a business becomes a corporation, it may offer for sale anywhere from several thousand to several million shares of stock. Such a stock offering might bring the company millions or even billions of dollars in new financial capital. It is easy to see why companies looking to expand might choose incorporation.

Ben & Jerry's offers a good example. Begun in 1978 as a partnership, the ice cream company became a corporation in 1984. That year, it offered stock to Vermont residents only, raising $750,000 for a new manufacturing facility. The following year, Ben & Jerry's stock was offered for sale to the general public. Using the revenue from stock sales, the company expanded its operations, distributing its ice cream outside of New England for the first time.

There are two kinds of business corporations. A **privately held corporation** is owned by an individual or a small group of individuals. It allows only a select group of people, often members of a family, to purchase stock. The stock is usually not for sale to the general public. A privately held corporation is also known as a **closely held corporation**.



If a privately held corporation grows significantly, it may take steps to become, or may be sold to, a publicly held corporation. A **publicly held corporation** offers stock for sale to the general public and has many shareholders. This is the type of corporation Ben & Jerry's became when it sold stock to the public. Stock in publicly held corporations is typically bought and sold through a stock exchange.

How Corporations Are Organized

Corporations all tend to be organized in much the same way. As shown in Figure 9.5A, the typical corporation is a hierarchy with different levels of employees. Every employee in a corporation reports to a higher-level employee. That person reports to an even higher-level employee, and so on. At the top of the corporate hierarchy sits the board of directors, which reports to the shareholders.

A **board of directors** is a governing body that is elected by the shareholders. The board oversees management of the corporation. It also establishes corporate policy and makes sure the company's resources are being managed effectively.

In many corporations, the board of directors is made up of "inside" as well as "outside" directors. An**inside director** is someone from within the firm, such as the company's founder or a senior-level manager. An **outside director** is someone from outside the firm who can provide an independent perspective.

One of the board's most important responsibilities is to select the corporation's **chief executive officer**. The CEO is the highest-ranking person in charge of managing a corporation.

The CEO usually appoints other **corporate officers**—senior executives who oversee specific areas of the business. For example, the chief financial officer (CFO) is in charge of a company's finances. The chief operating officer (COO) manages the day-to-day operations of a company. Other departments that are typically headed by corporate officers include marketing, legal, and information technology.

These corporate officers, along with other senior executives, make up the senior management of a corporation. Reporting to them is a broad swath of managers known as **middle management**. This next level includes vice presidents, department heads, and managers of various ranks. Middle management is responsible for supervising the day-to-day activities of the firm's workers.

Advantages of a Corporation

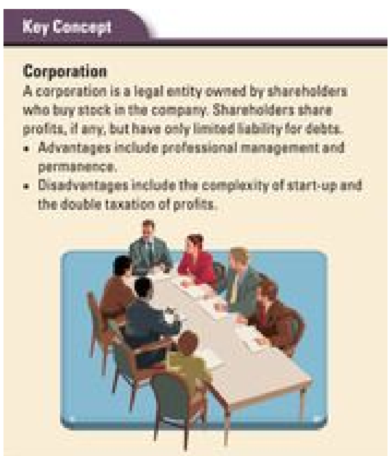
Businesses organized as corporations offer a number of advantages over sole proprietorships and partnerships.

Limited liability. A corporation's owners—the shareholders—are liable only for the amount of money they have invested. For example, suppose an investor buys 100 shares of stock at $30 a share. If the corporation goes bankrupt, the investor will lose that $3,000 investment. His or her personal assets are never at risk. The corporation is liable for its debts, however, because the law considers it a legal entity, like a person.

Growth potential. Because corporations can use the sale of stock to raise financial capital, they have far greater potential for growth than do other forms of business.For example, Google offered stock to the public in 2004 in what is called an **initial public offering**. On the first day of Google's IPO, 22 million shares were sold.This sale raised about $1.2 billion for the company.

Professional management. Whereas sole proprietors and partners must manage their businesses themselves, corporations are run by professional managers. These managers often specialize in a particular area, such as finance or public relations. With this expertise, corporations can increase efficiency to a level that often is not possible in smaller organizations.

Long life. Unlike sole proprietorships and partnerships, corporations continue to exist when founders die or owners sell their shares. As legal entities, corporations have permanence. For example, the company that became IBM Corporation was founded in 1888 and incorporated in 1911. Today it is one of the largest information technology employers in the world. This ability of corporations to continue indefinitely supports growth and long-range planning efforts.



Disadvantages of a Corporation

Although incorporation provides businesses with important advantages, it also has disadvantages.

Complexity of start-up. Businesses that want to incorporate are legally required to follow certain procedures.

•They must develop a prospectus. This document outlines for potential investors the main features of the enterprise and contains information about the stock being offered.

•They must apply for a business license. All states require new corporations to file a set of documents called **articles of incorporation**, also known as a corporate charter. A **corporate charter** details the company's objectives, structure, and planned operations. It also specifies the number of shares of stock that may be issued. When state officials approve the charter, the company becomes a legal corporation.

•They must create **corporate bylaws**, or rules that govern the management of the corporation. Bylaws deal with such topics as how to conduct shareholder meetings, how to elect directors, what officers the organization will have, and what the duties of those officers will be.

•They must hold a meeting of shareholders to elect a board of directors.

•They must issue stock certificates to shareholders. A **stock certificate** is a legal document that certifies ownership of a specific number of shares in the corporation.

Loss of control. Once a business has been incorporated, the role of the original owner or founder may change. Decisions once made by the founder become the responsibility of the board of directors and the professional management team. For the founder, the change usually means giving up some control of the company.

More government regulation. Corporations are subject to more government regulation than are other types of businesses. For example, corporations are required to hold annual shareholder meetings. They must maintain detailed records of business transactions. Publicly held corporations must also file regular reports with the Securities and Exchange Commission, the federal agency that regulates the stock market.

Double taxation. Corporations face heavier taxes than do sole proprietorships or partnerships. As legal entities, corporations are required to pay taxes on their profits.In addition, shareholders must pay income tax on any dividends they receive. Taxation at the corporate level and again at the shareholder level is known as **double taxation**.

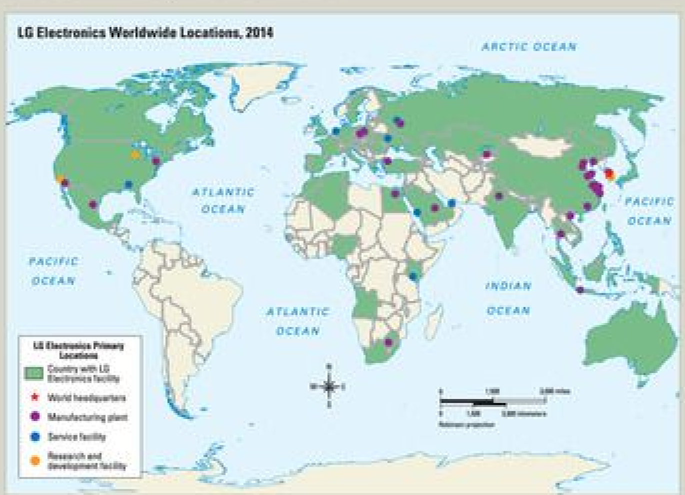


Figure 9.5B

Mapping a Multinational Corporation
In the past, most multinational corporations were based in Western Europe and North America. In recent decades, however, many Asian companies have gone global. The map shows the worldwide reach of LG Electronics, a multinational corporation based in South Korea.

Multinational Corporations: Doing Business on a Global Scale

Business enterprises that operate in more than one country—known as **multinational corporations**—are not new. They have existed since the 1600s, when English and Dutch trading companies first established outposts in the East Indies.

However, in the past few decades, the number of global businesses has skyrocketed. In 1990, there were about 3,000 multinational corporations. By 2009, there were more than 82,000 parent corporations with over 807,000 affiliates around the globe. Contrary to what many people think, not all of them are corporate giants like Coca-Cola and Exxon. Most are smaller firms having fewer than 250 employees.

As Figure 9.5B shows, such corporations typically have headquarters in their “home” country. They then operate production facilities or deliver services in at least one other country. Each branch of a multinational must obey the laws of the country in which it is located, including tax laws.

Multinational corporations have advantages that other firms do not have. Their global reach gives them access to more markets, with greater potential for increased sales and growth. Access to multiple markets also makes it less likely that a multinational will go bankrupt than will a smaller firm operating in a single market. Moreover, multinational corporations often have access to cheaper labor and raw materials than they would find in their home countries.Locations in multiple countries may also reduce their transportation costs. For all these reasons, the number of global corporations is likely to continue to increase.