**STUDY GUIDE FOR MODULE NO. 7**

**CHOOSING A FORM OF BUSINESS OWNERSHIP**

**MODULE OVERVIEW**

This module discusses the different forms of business organization, including sole proprietorships, partnerships, corporations and limited liability companies.

**MODULE LEARNING OBJECTIVES**

At the end of this module, you will:

* Discuss the differences among sole proprietorships, partnerships, corporations, and limited liability companies;
* Explain why most fast-growth entrepreneurial ventures organize as corporations or limited liability companies rather than sole proprietorships or partnerships.

**LEARNING CONTENTS (Choosing a Form of Business Ownership)**

When a business is launched, a form of legal entity must be chosen. The most common legal entities are:

* Sole Proprietorship
* Partnership
* Corporation
* Limited Liability Company

**Issues to Consider in Choosing a Legal Form of Business Ownership**

* The Cost of Setting Up and Maintaining the Legal Form
* The Extent to which Personal Assets can be shielded from the Liabilities of the Business
* Tax Considerations
* The Number and Types of Investors involved

**Sole Proprietorship**

* The simplest form of business entity is the sole proprietorship.
* A sole proprietorship is a form of business organization involving one person, and the person and the business are essentially the same.
* A sole proprietorship is not a separate legal entity. The sole proprietor is responsible for all the liabilities of the business, and this is a significant drawback.

**Advantages and Disadvantages of a Sole Proprietorship**

* Advantages of a Sole Proprietorship
* Creating one is easy and inexpensive.
* The owner maintains complete control of the business and retains all of the profits.
* Business losses can be deducted against the sole proprietor’s other sources of income.
* It is not subject to double taxation.
* The business is easy to dissolve.
* Disadvantages of a Sole Proprietorship
* Liability on the owners’ part is unlimited.
* The business relies on the skills and abilities of a single owner to be successful. Of course, the owner can hire employees who have additional skills and abilities.
* Raising capital can be difficult.
* The business ends at the owner’s death or loss of interest in the business.
* The liquidity of the owner’s investment is low.

**Partnerships**

* If two or more people start a business, they must organize as a partnership, corporation, or limited liability company.
* Partnerships are organized as either general or limited liability partnerships.

**General Partnership**

* A form of business organization where two or more people pool their skills, abilities, and resources to run a business. The primary disadvantage is that all partners are liable for all the partnership’s debts and obligations.

**Limited Partnership**

* A modified form of general partnership.
* The major difference between the two is that a limited partnership includes two classes of owners: general partners and limited partners.
* The general partners are liable for the debts and obligations of the partnership, but the limited partners are only liable up to the amount of their investment.

**Advantages and Disadvantages of a General Partnership**

* Advantages of a General Partnership
* Creating one is relatively easy and inexpensive compared to a corporation or limited liability company.
* The skills and abilities of more than one individual are available to the firm.
* Having more than one owner may make it easier to raise funds.
* Business losses can be deducted against the partners’ other sources of income.
* It is not subject to double taxation.
* Disadvantages of a General Partnership
* Liability on the part of each general partner is unlimited.
* The business relies on the skills and abilities of a fixed number of partners. Of course, the owners can hire employees who have additional skills and abilities.
* Raising capital can be difficult.
* Because decision making among the partners is shared, disagreements can occur.
* The business ends with the death or withdrawal of one partner unless otherwise stated in the partnership agreement.
* The liquidity of each partner’s investment is low.

**Corporations**

* A corporation is a separate legal entity organized under the authority of a state.
* Corporations are organized as either C corporations or subchapter S corporations.
* C corporations are what most people think of when they hear the word “corporation.” However, business startups are often organized as subchapter S corporations.

**C Corporations**

* Is a separate legal entity that, in the eyes of the law, is separate from its owners.
* In most cases a corporation shields its owners, who are called shareholders, from personal liability for the debts of the corporation.
* A corporation is governed by a board of directors, which is elected by the shareholders.
* A corporation is formed by filing articles of incorporation.
* A corporation is taxed as a separate legal entity.
* A disadvantage of a C corporation is that it is subject to double taxation. This means that a corporation is taxed on its net income, and when the same income is distributed to shareholders in the form of dividends, the income is taxed again on the shareholders’ personal tax returns.

**Advantages and Disadvantages of a C Corporation**

* Advantages of a C Corporation
* Owners are liable only for the debts and obligations of the corporation up to the amount of their investment.
* The mechanics of raising capital is easier.
* No restrictions exist on the number of shareholders, which differs from subchapter S corporations.
* Stock is liquid if traded on a major stock exchange.
* The ability to share stock with employees through stock options or other incentive plans can be a powerful form of employee motivation.
* Disadvantages of a C Corporation
* Setting up and maintaining one is more difficult than for a sole proprietorship or a partnership.
* Business losses cannot be deducted against the shareholder’s other sources of income.
* Income is subject to double taxation, meaning that it is taxed at the corporate and the shareholder levels.
* Small shareholders typically have little voice in the management of the firm.

**Subchapter S Corporation**

* Combines the advantages of a partnership and a C corporation.
* Is similar to a partnership in that the income of the business is not subject to double taxation.
* Is similar to a corporation in that the owners are not subject to personal liability for the debts or behavior of the business.
* A Subchapter S Corporation does not pay taxes. Profits and losses are passed through to the tax returns of the owners.
* There are strict standards that a business must meet to qualify for status as a subchapter S corporation. The standards are stated below:
* The business cannot be a subsidiary of another corporation.
* Partnerships and C corporations may not own shares in a subchapter S corporation. Certain types of trusts and estates are eligible to own shares in a subchapter S corporation.
* It can only have one class of stock issued and outstanding (either preferred stock or common stock).
* It can have no more than 100 members. Husbands and wives count as one member, even if they own separate shares of stock.
* All shareholders must agree to have the corporation formed as a subchapter S corporation.

**Limited Liability Company**

* Is a form of business ownership that is rapidly gaining popularity in the U.S.
* Along with the Subchapter S, it is a popular choice for start-up firms.
* The limited liability company combines the limited liability advantage of the corporation with the tax advantages of a partnership.
* A limited liability company does not pay taxes. Profits and losses are passed through to the tax returns of the owners.

**Advantages and Disadvantages of a Limited Liability Company**

* Advantages of a Limited Liability Company
* Members are liable for the debts and obligations of the business only up to the amount of their investment.
* The number of shareholders is unlimited.
* An LLC can elect to be taxed as a sole proprietor, partnership, S corporation, or corporation, providing much flexibility.
* Because profits are taxed only at the shareholder level, there is no double taxation.
* Disadvantages of a Limited Liability Company
* Setting up and maintaining one is more difficult and expensive.
* Tax accounting can be complicated.
* Some of the regulations governing LLCs vary by state.
* Because LLCs are a relatively new type of business entity, there is not as much legal precedent available for owners to anticipate how legal disputes might affect their business.
* Some states levy a franchise tax on LLCs—which is essentially a fee the LLC pays the state for the benefit of limited liability.

**LEARNING ACTIVITY 1**

Application Questions:

1. Determine specifically what the requirements are for starting a limited liability company in the country. Indicate what forms need to be filled, where they can be obtained, how the filing process works and what fees are involved.

2. Samuel Smith, a friend of yours, is a freelance journalist. He writes articles on business topics and sells them to business periodicals, newspapers, and online sites. Samuel just read an article about the advantages of organizing as a subchapter S corporation or an LLC but doesn’t know if the article applies to him. He’s currently organized as a sole proprietorship, and doesn’t know if it’s appropriate or advisable for a freelance journalist to set up a subchapter S corporation or an LLC. Samuel has turned to you for advice. What would you tell him?

**LEARNING ACTIVITY 2**

Identify the following terms asked in every number.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 1. A form of business organization where two or more people pool their skills, abilities, and resources to run a business.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 2. The simplest form of business entity.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 3. A form of business ownership that combines the limited liability advantage of the corporation with the tax advantages of a partnership.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 4. This is similar to a partnership in that the income of the business is not subject to double taxation.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 5. A form of business organization involving one person, and the person and the business are essentially the same.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 6. This is a separate legal entity that is separate from its owners.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 7. This is similar to a corporation in that the owners are not subject to personal liability for the debts or behavior of the business.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 8. A modified form of general partnership.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 9. It is a separate legal entity organized under the authority of a state.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ 10. It combines the advantages of a partnership and a C corporation.

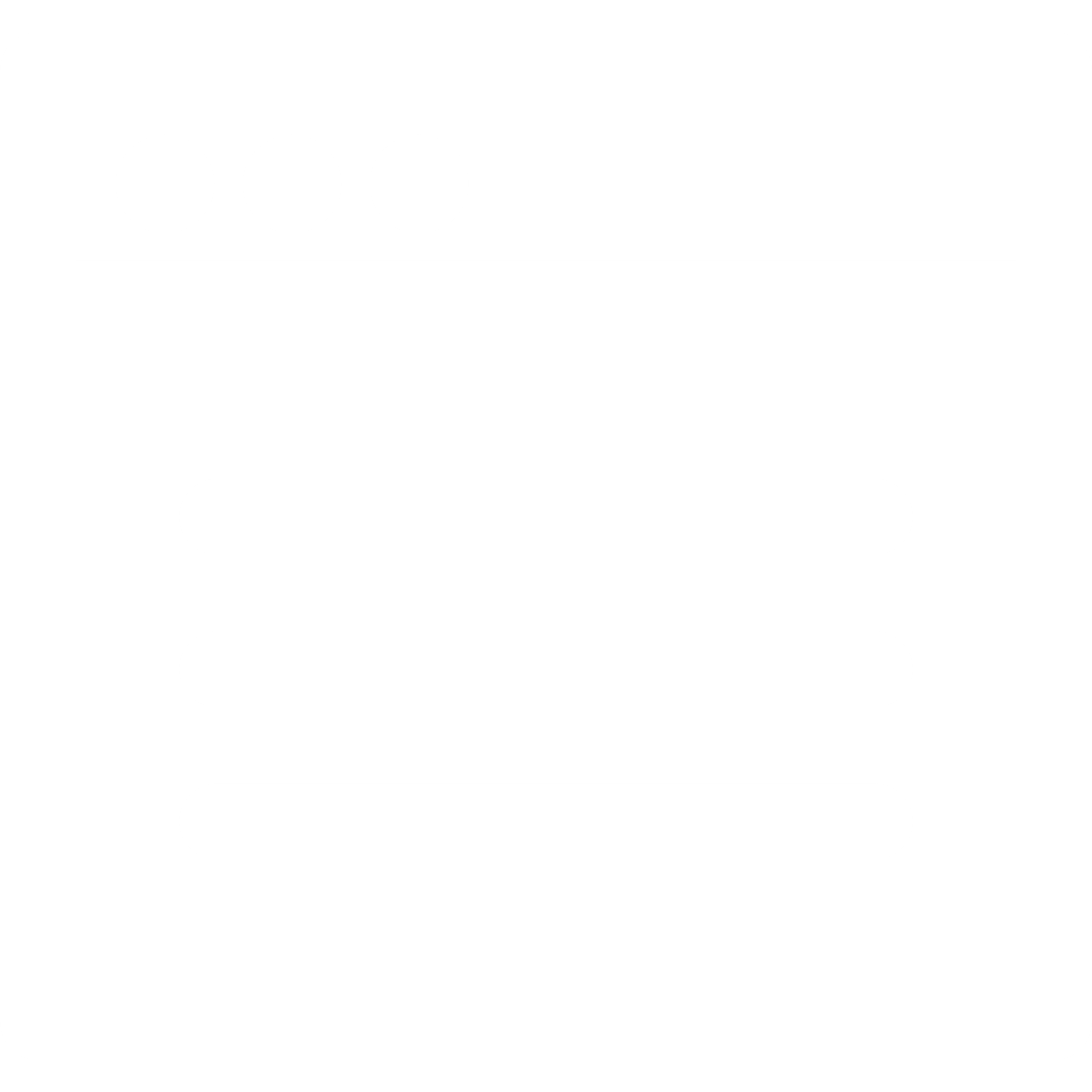
**LEARNING ACTIVITY 3**

In your own words, answer the following questions:

1. What are the advantages and disadvantages of organizing a new firm as a sole proprietorship? Is a sole proprietorship an appropriate form of ownership for an aggressive entrepreneurial firm? Why or why not?
2. Describe the differences between a general partnership and a limited partnership. Is a general partnership an appropriate form of ownership for two people pooling their resources to start a high-growth entrepreneurial firm?
3. What are the advantages and disadvantages of a limited liability company? Is a limited liability company an appropriate form of ownership for an aggressive entrepreneurial firm?

**SUMMARY**

* Sole proprietorship, partnerships, corporations and limited liability companies are the most common legal entities from which entrepreneurs make a choice. These forms of business organization differ in terms of the number of owners allowed, cost of setting up and maintaining, personal liability of owners, continuity of the business, methods of taxation, degree of management control, ease of raising capital and ease of liquidating investments.
* Fast-growth firms tend to organize as corporations or limited liability companies for two main reasons: to shield the owners from personal liability for the behavior of the firm and to make it easier to raise capital.

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