1.2: Forms of Business Organization

There are three basic forms of business organizations – sole proprietorships, partnerships, and corporations. Our focus this semester will be on the corporation, but at this point we should introduce all three forms (in a simplified manner) to give the basic framework of each.

Sole Proprietorship

A sole proprietorship is a business organization where the owner is a single person and is solely responsible for control of the business. While the owner can hire employees (and managers), it is ultimately the owner that is in charge. One important characteristic of a sole proprietorship is that, from a legal and tax perspective, there is no real distinction between the owner and the business. The owner is liable (legally and financially) for the actions and liabilities of the business. Also, the income is only taxed once (as opposed to being taxed at both the business and personal level).

Partnership

A partnership is structured much like a sole proprietorship except that now there are multiple owners. Again, there is no distinction between the owners and the business as they are all liable (legally and financially) for the actions and liabilities of the business. Also, like in a sole proprietorship, the income is only taxed once. In practice, there are different types of partnerships (general vs. limited vs. limited liability). The general partnership is what is described above. A limited partnership involves at least one general partner to manage the company and take on the risk. The limited partners are passive investors. Finally, a limited liability partnership allows partners to limit their legal (limited to each partner's behavior) and financial liability (limited to the assets of the business) while still maintaining the tax structure of a general partnership. Note that specifics of partnership law vary by country and by state.

Corporation

A corporation is a firm owned by many individuals (stockholders) who in most cases have little input in operating the firm. A fundamental component of the corporate form of ownership is the separation of ownership from the process of managing the firm. The owners (stockholders) elect a board of directors who are responsible for hiring management and overseeing the direction of the firm's operations. Corporations account for the bulk of business activity in the US because most large firms are organized as corporations. Specifically, while approximately 17% of business tax returns were filed by corporations, they accounted for about 82% of total revenues by businesses and 62% of taxable income according to IRS SOI Tax Stats in 2015. Because most large firms are organized as corporations, accounting for the bulk of business activity, and corporations are more complex, we will focus on the corporation in our coverage of finance this semester.