

17.5: Sole Proprietorships

Learning Objectives

- Define sole proprietorship
- Discuss the advantages and disadvantages of sole proprietorship

A sole proprietorship is the simplest and most common legal structure someone can choose. It's an unincorporated business owned and run by one individual in which there is no distinction between the business and the owner. If you own a sole proprietorship, you are entitled to all profits and are responsible for all your business's debts, losses, and liabilities.

Forming a Sole Proprietorship



You don't have to take any formal action to form a sole proprietorship. As long as you are the only owner, this status automatically arises from your business activities. In fact, you may already own one without knowing it. If you are a freelance writer, for example, you are a sole proprietor.

As is the case when you own any kind of business, you may need to obtain the necessary licenses and permits. For example, certain businesses, like ones that sell alcohol or firearms, require a federal license or permit. Some states have requirements for other specific businesses. Additionally, some professions such as Certified Public Accountants (CPAs) may have licensing or certification requirements that must be met before you can promote yourself as engaging in that business or trade. Regulations vary by industry, state, and locality.

If you choose to operate under a name different from your own, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name—short for “doing business as”). This document is usually filed in the records of the county or city in which you do business. This requirement exists because if customers want to contact (or sue) the person running the business, the law requires the owner to inform the public of the person behind the “business.” You must choose an original name; it cannot already be claimed by another business. In order to check the availability of a business name, business owners may search the database maintained by the State Secretary of State. Visit this webpage to [learn about naming your business](#).

Practice Question

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Sole Proprietor Taxes

Because you and your business are one and the same, the business itself is not taxed separately—the sole proprietorship income is *your* income. It's your responsibility to withhold and pay all income taxes, including self-employment and estimated taxes.

Advantages of a Sole Proprietorship

Sole proprietorships have several advantages that make them popular:

- **Easy and inexpensive to form.** As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.

- **Profits all go to the owner.** The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- **Direct control of the business.** All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- **Freedom from government regulation.** Sole proprietorships have more freedom than other forms of business with respect to government controls.
- **No special taxation.** Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- **Ease of dissolution.** With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of a Sole Proprietorship

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- **Unlimited liability.** From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.
- **Difficulty raising capital.** Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.
- **Limited managerial expertise.** The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- **Trouble finding qualified employees.** Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favorable employment opportunities.
- **Personal time commitment.** Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- **Unstable business life.** The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- **Losses are the owner's responsibility.** The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

✓ TW's Construction

Tareq has decided that he wants to start a construction company. Given how easy it is to establish a sole proprietorship, Tareq decides that this is the form of ownership he'll choose. He doesn't need to borrow any money to start his business, and since he will be doing all the work himself, at this point he isn't worried that this type of ownership will add additional burdens or stress. He also likes the idea that he is in control of which jobs he takes and who his customers are.

He calls, Luana, his accountant, and asks her about the taxes, because that part is still a little unclear to him. She explains that when Tareq was working for his previous employer, Elliot Builders, federal and state income taxes were withheld from his paychecks. Elliot Builders then sent those funds to the IRS and state department of revenue on Tareq's behalf. Those were the taxes he got credit for when he filed his tax return at the end of the year. Elliot Builders also paid half his social security and medicare taxes for Tareq. The company also paid into the state unemployment insurance fund in case an employee ever filed for unemployment benefits.

Luana tells Tareq that now, as a sole proprietor, he'll need to plan for taxes throughout the year, not just in April—no one else will be withholding or paying taxes for him. This isn't the kind of news Tareq wanted, but he is happy to learn that he may be able to deduct many of the expenses he incurs in the course of operating his business. These include things like his work van, tools he purchases, office supplies, and possibly the small office he has set up in his home. Luana recommends that Tareq come see her at the end of each fiscal quarter (March, June, September, and December) to make sure that he is on track with his taxes for the year. He thinks this is great advice and schedules the appointments on the spot.

After leaving Luana's office, Tareq goes to the courthouse and files his DBA certificate (for the name of his business) and begins operating as a sole proprietorship: TW's Construction. Lastly, he stops by his insurance agent and makes sure that he has the proper insurance on his vehicles and equipment, verifying that he has sufficient liability insurance to cover any potential claims against him.

He heads home to start calling homeowners and setting up appointments to bid on jobs. He has joined the ranks of the self-employed!

? Practice Question

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