

## 1.3: Selecting a Legal Form for a Business

### Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Describe the three primary legal forms available for a business.
2. List and discuss the advantages and disadvantages of incorporating a business rather than maintaining a sole proprietorship or partnership.
3. Explain the double taxation that is inherent in operating a corporate organization.
4. Describe the impact that the possibility of issuing capital stock has on a corporation.

*Question: In the United States, businesses and other organizations must operate under one of three legal forms<sup>1</sup>. A **proprietorship** is created by a single owner whereas a **partnership** is started and owned by two or more parties. Establishing ownership is often quite informal. In contrast, a **corporation** comes into existence by means of a formal request made to the state government. The number of owners is usually not relevant in creating a corporation. Because corporations are the dominant legal form (at least monetarily) in the world, they have been the primary emphasis throughout this text. Numerically, more proprietorships and partnerships do exist but virtually every business of any size operates as a corporation. How is a corporation established, and what characteristics make it attractive?*

*Answer:* Incorporation of an entity is only required in one state regardless of its size. To start this process, the original owners submit articles of incorporation to that government<sup>2</sup>. Rules, regulations, and requirements vary significantly so that these procedures are more complicated in some states than others. For example, many well-known businesses are incorporated in Delaware because of the ease of complying with the laws in that state.

After all documents have been filed and all other requirements met, the state government issues a corporate charter that recognizes the organization as a legal entity separate from its ownership. This separation of the ownership is what differentiates a corporation from a partnership or proprietorship. Following incorporation in one state, the entity is then allowed to operate in any other state.

As mentioned in a previous section, ownership of a corporation is divided into shares of stock that are issued to raise funds. In general, these shares are referred to as capital stock and the owners as shareholders or stockholders. For example, at December 31, 2022, the stockholders of Tesla Company held approximately 3,164 million of these shares. Unless restricted contractually, capital stock can be exchanged freely. Once issued by a corporation, shares can be resold dozens or even hundreds of times. Operations are usually unaffected by these ownership changes. Information about the current market price of most stocks as well as a considerable amount of other information can be found at <http://www.google.com/finance> and <http://www.yahoo.com/finance>.

Thus, a corporation is able to continue in existence even after owners die or decide to switch to other investments. In partnerships and proprietorships, capital stock does not exist. Consequently, the transfer of an ownership interest is much more complicated. Partnerships and proprietorships often operate only for as long as the original owners are willing and able to continue being actively involved.

As a result of the legal separation of ownership and business, shareholders have no personal liability for the debts of the corporation<sup>3</sup>. An owner of a share of Tesla is not responsible for any of the liabilities of that company. The maximum loss a shareholder can suffer is the amount contributed to the business (or paid to a previous owner) in acquiring capital stock.

In contrast, the owners of a partnership or proprietorship are personally liable for all business debts. No separation exists between the business and the ownership. A partner or proprietor could invest \$1,000 but wind up losing almost any amount if funds are borrowed by the business that cannot be repaid. Such potential losses are especially worrisome in a partnership where each partner serves as an agent for the entire organization. Under the concept of **mutual agency**, any partner can obligate the partnership and, if the debt is not paid when due, the creditor can seek redress from any other partner. The **limited liability** offered by a corporation is one of the primary reasons for its popularity. Investors have a strong preference for being able to limit the amount of money at risk.

*Question: Ownership shares of most corporations can be transferred. Thus, the life of a corporation can extend indefinitely. Caswell-Massey Co., a “purveyor of luxury personal care products,” was incorporated in 1752 in Rhode Island and continues to do business today.*

*Investors are able to move into and out of these investments quickly. In addition, the availability of limited liability restricts potential losses to the amounts invested. These characteristics help explain the immense popularity of the corporate form. However, a significant number of partnerships and proprietorships still come into existence each year. If no problems were possible, incorporation would be the only practical option. What disadvantages are associated with corporations?*

Answer: Incorporation is often a time consuming and costly legal process. However, in most states, proprietorships and partnerships can be created informally with little effort. Owners of many small businesses feel that the creation of a corporation is more trouble than it is worth. Furthermore, corporations are often more susceptible to a plethora of government regulations.

The most obvious problem associated with corporations is the **double taxation** of income. As noted, proprietorships and partnerships are not deemed to be entities separate from their owners. Therefore, income is taxed only one time. Owners pay that tax when the income is earned by their business. For a proprietorship, Schedule C is an income statement attached to the owner's individual Form 1040 income tax return to include the business's profit or loss. A partnership does file its own return on Form 1065 but that is merely for information purposes; no income tax is paid. Instead, the various business revenues and expenses are assigned to the partners for inclusion on their individual tax returns. Any eventual conveyance of this income from business to owner does not create a second tax.

In contrast, corporations are separate legal entities that pay their own taxes by filing Form 1120 to report all taxable income that has been earned<sup>4</sup>. However, when any dividends are eventually distributed from those earnings to the stockholders, this transfer is also viewed as taxable income to the owner. Income is taxed once when earned by the corporation and again when distributed to the owners. Critics have long argued that the collection of the dividend is not a new earning process. To mitigate the impact of this second tax, the United States Congress has established a maximum tax rate of 20 percent on much of the dividend income collected by individuals. This rate is considerably lower than that applied to most other types of income.

To illustrate, assume that income tax rates are 30 percent except for the 20 percent tax on dividends. A proprietorship (or partnership) earns a profit of \$100. In this type business, the \$100 is only taxable to the owner or owners when earned. Payment of the resulting \$30 income tax ( $\$100 \times 30$  percent) leaves \$70. This is the remaining disposal income. Any distribution of this money has no impact on taxes.

If a corporation reports this same amount of income, a tax of \$30 is assessed to the business so that only \$70 remains. This income can then be conveyed as a dividend. However, another tax must be paid, this time by the stockholder. The second income tax is \$10.50 ( $\$70 \times 15$  percent). The owner is left with only \$59.50 ( $\$70.00$  less  $\$10.50$ ) in disposal income. The increase in the amount taken by the government (\$40.50 versus \$30.00 on \$100 of taxable income) is significant enough to reduce the inclination of many owners to incorporate their businesses.

### Check Yourself

Which of the following is an important difference between a partnership and a corporation?

- A. Partnerships can have multiple owners but a corporation cannot.
- B. Partners are liable for the obligations of the partnerships while shareholders in the corporation are not liable for the debts of the corporation
- C. Corporation shareholders cannot legally sell their shares to others but partners can sell their partnership interests to others.
- D. Partners in a partnership are subject to double taxation on the earnings while shareholders in a corporation are not.

Correct answer is B. Keeping the shareholders legally separate and thus not liable for the debts of a corporation is the primary reason for adopting the corporate form of business ownership. It is important to remember that the separation is only enforceable in court if the corporation follows the rules of corporations and keeps the shareholders financial separate in day to day operations.

### Key Takeaway

Businesses can exist as corporations, partnerships, or sole proprietorships. A corporation differs from the other two forms because it is an entity legally separate from its ownership. Thus, the liability of owners is limited to the amount of their investments. Corporations are formed according to individual state laws. Shares of the ownership of a corporation (capital stock) are issued to raise money for operations and growth. In many cases, these shares can be readily sold by one owner to the next, often on a stock exchange. The ability to buy and sell capital shares enables a corporation to raise funds and have a continuous life. Disadvantages associated with the corporate form include the cost and difficulty of incorporation and government regulation. The double taxation of corporate income (which is not found with partnerships and sole proprietorships) is often the biggest drawback to incorporation.

<sup>1</sup>In recent decades, a number of variations of these legal forms have been allowed, each with its own particular characteristics. For example, limited liability companies (LLCs) and limited liability partnerships (LLPs) are hybrids that exhibit characteristics of both partnerships and corporations and are permitted to exist in certain states.

<sup>2</sup>A list of the typical contents of the articles of incorporation can be found at “Articles of Incorporation,” [http://en.wikipedia.org/wiki/Articles\\_of\\_Incorporation](http://en.wikipedia.org/wiki/Articles_of_Incorporation).

<sup>3</sup>When money is loaned to a corporation, especially one that is either new or small, the lender might require the owners to personally guarantee the debt. However, unless such a guarantee is made, the debt is that of the corporation and not the members of the ownership.

<sup>4</sup>Tax rules do allow smaller corporations to file their income taxes as S corporations if certain guidelines are met. S corporations follow virtually the same tax rules as partnerships so that income is only taxed one time when initially earned.

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