

## 12.4: Legal Forms of Organization for the Small Business

### Learning Objectives

1. Understand the different legal forms that a small business can take.
2. Explain the factors that should be considered when choosing a legal form.
3. Understand the advantages and disadvantages of each legal form.
4. Explain why the limited liability company may be the best legal structure for many small businesses.

Every small business must select a legal form of ownership. The most common forms are sole proprietorship, partnership, and corporation. A limited liability company (LLC) is a relatively new business structure that is now allowed by all fifty states. Before a legal form is selected, however, several factors must be considered, not the least of which are legal and tax options.

### Factors to Consider

The legal form of the business is one of the first decisions that a small business owner will have to make. Because this decision will have long-term implications, it is important to consult an attorney and an accountant to help make the right choice. The following are some factors the small business owner should consider before making the choice: [citation redacted per publisher request]; “Small Business Planner: Choose a Structure,” *US Small Business Association*, accessed February 3, 2012, [archive.sba.gov/smallbusinessplanner/start/choosestructure/index.html](http://archive.sba.gov/smallbusinessplanner/start/choosestructure/index.html).

- **The owner’s vision.** Where does the owner see the business in the future (size, nature, etc.)?
- **The desired level of control.** Does the owner want to own the business personally or share ownership with others? Does the owner want to share responsibility for operating the business with others?
- **The level of structure.** What is desired—a very structured organization or something more informal?
- **The acceptable liability exposure.** Is the owner willing to risk personal assets? Is the owner willing to accept liability for the actions of others?
- **Tax implications.** Does the owner want to pay business income taxes and then pay personal income taxes on the profits earned?
- **Sharing profits.** Does the owner want to share the profits with others or personally keep them?
- **Financing needs.** Can the owner provide all the financing needs or will outside investors be needed? If outside investors are needed, how easy will it be to get them?
- **The need for cash.** Does the owner want to be able to take cash out of the business?

The final selection of a legal form will require consideration of these factors and tradeoffs between the advantages and disadvantages of each form. No choice will be perfect. Even after a business structure is determined, the favorability of that choice over another will always be subject to changes in the laws. “Limited Liability Company,” *Entrepreneur.com*, July 9, 2007, accessed February 3, 2012, [www.entrepreneur.com/article/24484](http://www.entrepreneur.com/article/24484).

### Sole Proprietorship

A **sole proprietorship** is a business that is owned and usually operated by one person. It is the oldest, simplest, and cheapest form of business ownership because there is no legal distinction made between the owner and the business (see Table 12.4.1). Sole proprietorships are very popular, comprising 72 percent of all businesses and nearly \$1.3 trillion in total revenue. US Internal Revenue Service, “Selected Returns and Forms Filed or to Be Filed by Type During Specified Calendar Years 1980–2005,” SOI Bulletin, Historical Table, Fall 2004, as cited in John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60. Sole proprietorships are common in a variety of industries, but the typical sole proprietorship owns a small service or retail operation, such as a dry cleaner, accounting services, insurance services, a roadside produce stand, a bakery, a repair shop, a gift shop, painters, plumbers, electricians, and landscaping services. John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60; adapted from David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163. Clearly, the sole proprietorship is the choice for most small businesses.

Table 12.4.1: Sole Proprietorships: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages

Liability	Taxes	Advantages	Disadvantages
Unlimited: owner is responsible for all the debts of the business.	No special taxes; owner pays taxes on profits; not subject to corporate taxes	<ul style="list-style-type: none"> <li>• Tax breaks</li> <li>• Owner retains all profits</li> <li>• Easy to start and dissolve</li> <li>• Flexibility of being own boss</li> <li>• No need to disclose business information</li> <li>• Pride of ownership</li> </ul>	<ul style="list-style-type: none"> <li>• Owner absorbs all losses</li> <li>• Unlimited liability</li> <li>• Difficult to get financing</li> <li>• Management deficiencies</li> <li>• Lack of stability in case of injury, death, or illness</li> <li>• Time demands</li> <li>• Difficult to hire and keep highly motivated employees</li> </ul>

Source: John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 60; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; “[How to Choose the Right Business Structure for Your Small Business](#),” *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150–51.

## Partnership

A **partnership** is two or more people voluntarily operating a business as co-owners for profit. Partnerships make up more than 8 percent of all businesses in the United States and more than 11 percent of the total revenue. William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150. Like the sole proprietorship, the partnership does not distinguish between the business and its owners (see Table 12.2). There should be a legal agreement that “sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, and what steps will be taken to dissolve the partnership when needed.” “Small Business Planner: Choose a Structure,” *US Small Business Association*, accessed February 3, 2012, [archive.sba.gov/smallbusinessplanner/start/choosestructure/index.html](http://archive.sba.gov/smallbusinessplanner/start/choosestructure/index.html).

There are two types of partnerships. In the **general partnership**, all the partners have unlimited liability, and each partner can enter into contracts on behalf of the other partners. A **limited partnership** has at least one general partner and one or more limited partners whose liability is limited to the cash or property invested in the partnership. Limited partnerships are usually found in professional firms, such as dentists, lawyers, and physicians, as well as in oil and gas, motion-picture, and real-estate companies. However, many medical and legal partnerships have switched to other forms to limit personal liability. John M. Ivancevich and Thomas N. Duening, *Business: Principles, Guidelines, and Practices* (Mason, OH: Atomic Dog Publishing, 2007), 60; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 150.

Before creating a partnership, the partners should get to know each other. According to Michael Lee Stallard, cofounder and president of E Pluribus Partners, a consulting firm in Greenwich, Connecticut, “The biggest mistake business partners make is jumping into business before getting to know each other...You must be able to connect to feel comfortable expressing your opinions, ideas and expectations.” Shelley Banjo, “[Before You Tie the Knot...](#),” *Wall Street Journal*, November 26, 2007, accessed February 3, 2012.

Table 12.4.2: Partnerships: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages

Liability	Taxes	Advantages	Disadvantages
Unlimited for general partner; limited partners risk only their original investment.	Individual taxes on business earnings; no income taxes as a business	<ul style="list-style-type: none"> <li>• Owner(s) retain all profits</li> <li>• Unlimited for general partner; limited partners risk only their original investment. Individual taxes on business earnings; no income taxes as a business</li> <li>• Easy to form and dissolve</li> <li>• Greater access to capital</li> <li>• No special taxes</li> <li>• Clear legal status</li> <li>• Combined managerial skills</li> <li>• Prospective employees may be attracted to a company if given incentive to become a partner</li> </ul>	<ul style="list-style-type: none"> <li>• Unlimited financial liability for general partners</li> <li>• Interpersonal conflicts</li> <li>• Financing limitations</li> <li>• Management deficiencies</li> <li>• Partnership terminated if one partner dies, withdraws, or is declared legally incompetent</li> <li>• Shared decisions may lead to disagreements</li> </ul>

Source: John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; David L. Kurtz, *Contemporary Business, 13th Edition Update* (Hoboken, NJ: John Wiley & Sons, 2011), 163; “[How to Choose the Right Business Structure for Your Small Business](#),” *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 154–55; “[Small Business Planner—Choose a Structure](#),” *US Small Business Administration*, accessed February 3, 2012.

## Corporation

A **corporation** “is an artificial person created by law, with most of the legal rights of a real person. These include the rights to start and operate a business, to buy or sell property, to borrow money, to sue or be sued, and to enter into binding contracts” William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 157. (see Table 12.3). Corporations make up 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue. Jeff Madura, *Introduction to Business* (St. Paul, MN: Paradigm Publishers International, 2010), 150. Although some small businesses are incorporated, many corporations are extremely large businesses—for example, Walmart, General Electric, Procter & Gamble, and Home Depot. Recent data show that only about one-half of the small business owners in the United States run incorporated businesses. Matthew Bandyk, “[Turning Your Small Business into a Corporation](#),” *US News & World Report*, March 14, 2008, accessed February 3, 2012.

Scott Shane, author of *The Illusions of Entrepreneurship* (Yale University Press, 2010), argues that small businesses that are incorporated have a much higher rate of success than sole proprietorships, outperforming unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures. Matthew Bandyk, “[Turning Your Small Business into a Corporation](#),” *US News & World Report*, March 14, 2008, accessed February 3, 2012. Shane maintains that being incorporated may not make sense for “tiny little businesses” because the small amount of risk may not be worth the complexity. However, Deborah Sweeney, incorporation expert for Intuit, disagrees, saying that “even the smallest eBay business has a risk of being sued” because shipping products around the country or the world can create legal problems if a shipment is lost. Matthew Bandyk, “[Turning Your Small Business into a Corporation](#),” *US News & World Report*, March 14, 2008, accessed February 3, 2012. Ultimately, it is the small business being successful that may be the biggest factor for the owner to move from a sole proprietorship to a corporation.

Table 12.4.3: Corporations: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages

Liability	Taxes	Advantages	Disadvantages
Limited;	multiple taxation	<ul style="list-style-type: none"> <li>Limited liability</li> <li>Skilled management team</li> <li>Ease of raising capital</li> <li>Easy to transfer ownership by selling stock</li> <li>Perpetual life</li> <li>Legal-entity status</li> <li>Economies of large-scale operations</li> </ul>	<ul style="list-style-type: none"> <li>Double taxation</li> <li>Difficult and expensive to start</li> <li>Individual stockholder has little control over operations</li> <li>Financial disclosure</li> <li>Lack of personal interest unless managers are also stockholders</li> <li>Credit limitations</li> <li>Government regulation and increased paperwork</li> </ul>

Source: “[How—and Why—to Incorporate Your Business](#),” *Entrepreneur*, accessed February 3, 2012, ; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; “[How to Choose the Right Business Structure for Your Small Business](#),” *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 154–55.

## Limited Liability Company

The **limited liability company** is a relatively new form of business ownership that is now permitted in all fifty states, although the laws of each state may differ. The LLC is a blend of a sole proprietorship and a corporation: the owners of the LLC have limited liability and are taxed only once for the business. “[How to Choose the Right Business Structure for Your Small Business](#),” *National Federation of Independent Business*, accessed February 3, 2012. The LLC provides all the benefits of a partnership but limits the liability of each investor to the amount of his or her investment (see Table 12.4.4). “LLCs were created to provide business owners with the liability protection that corporations enjoy without the double taxation.” “[Limited Liability Company](#),” *Entrepreneur.com*, July 9, 2007, accessed February 3, 2012.

According to Carter Bishop, a professor at Suffolk University Law School, who helped draft the uniform LLC laws for several states, “There’s virtually no reason why a small business should file as a corporation, unless the owners plan to take the business public in the near future.” Annalyn Censky, “[Business Structures 101](#),” *CNN Money*, August 4, 2008, accessed February 3, 2012. In the final analysis, the LLC business structure is the best choice for most small businesses. The owners will have the greatest flexibility, and there is a liability shield that protects all owners. Annalyn Censky, “[Business Structures 101](#),” *CNN Money*, August 4, 2008, accessed February 3, 2012.

Table 12.4.4: Limited Liability Companies: A Summary of Characteristics

Liability	Taxes	Advantages	Disadvantages
Limited;	owners taxed at individual income tax rate	<ul style="list-style-type: none"> <li>Limited liability</li> <li>Taxed at individual tax rate</li> <li>Shareholders can participate fully in managing company</li> <li>No limit on number of shareholders</li> <li>Easy to organize</li> <li>LLC members can agree to share profits and losses disproportionately</li> </ul>	<ul style="list-style-type: none"> <li>Difficult to raise money</li> <li>No perpetual life</li> <li>Is dissolved at death, withdrawal, resignation, expulsion, or bankruptcy of one member unless there is a vote to continue</li> <li>No transferability of membership without the majority consent of other members</li> </ul>

Source: Annalyn Censky, “[Business Structures 101](#),” *CNN Money*, August 4, 2008, accessed February 3, 2012; “[Limited Liability Company](#),” *Entrepreneur.com*, accessed February 3, 2012; John M. Ivancevich and Thomas N. Duening, *Business: Principles, Practices, and Guidelines* (Mason, OH: Atomic Dog Publishing, 2007), 64–65; “[How to Choose the Right Business Structure for](#)

[Your Small Business](#),” *National Federation of Independent Business*, accessed February 3, 2012; William M. Pride, Robert J. Hughes, and Jack R. Kapoor, *Business* (Boston: Houghton Mifflin, 2008), 159.

### KEY TAKEAWAYS

- Every small business must select a legal form of ownership. It is one of the first decisions that a small business owner must make.
- The most common forms of legal structure are the sole proprietorship, the partnership, and the corporation. An LLC is a relatively new business structure.
- When deciding on a legal structure, every small business owner must consider several important factors before making the choice.
- The sole proprietorship is the oldest, simplest, and cheapest form of business ownership. This business structure accounts for the largest number of businesses but the lowest amount of revenue. This is the choice for most small businesses.
- A partnership is two or more people voluntarily operating a business as co-owners for profit. There are general partnerships and limited partnerships.
- A corporation is an artificial person with most of the legal rights of a real person. Corporations make up about 20 percent of all businesses in the United States, but they account for almost 90 percent of the revenue.
- Small businesses that are incorporated outperform unincorporated small businesses in terms of profitability, employment growth, sales growth, and other measures.
- The LLC is a hybrid of a sole proprietorship and a corporation. It is the best choice for most small businesses.

### EXERCISES

1. Select three small businesses of different sizes: small, medium, and large. Interview the owners, asking each about the legal structure that the owner chose and why. If any of the businesses are sole proprietorships, ask the owner if an LLC was considered. If not, try to find out why it was not considered.
2. Frank's BarBeQue is currently a sole proprietorship. Frank's son, Robert, is trying to persuade his father to either incorporate or become an LLC. Assume that you are Robert. Make a case for each legal structure and then make a recommendation to Frank. It is expected that you will go beyond the textbook in researching your response to this assignment.

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