3.3 CHOOSE THE LEGAL FORM OF YOUR BUSINESS

JUMP START

After careful consideration, Abbie and Kaito decided to start their own business. Now they had to decide what form of business ownership would work best for them. Abbie and Kaito could form a legal partnership and draw up a partnership agreement. But they also wanted to consider the advantages and disadvantages of incorporating their business because they liked the idea of limiting their liability. Someone suggested they look into incorporating as an S corporation. What advice would you give them?

GOALS

Compare a sole proprietorship and a partnership

Describe a corporation

KEY TERMS

sole proprietorship, p. 75
partnership, p. 75
corporation, p. 75
share of stock, p. 78
board of directors, p. 78
dividends, p. 78
liability, p. 79

Forms of Business Ownership

Once you decide to start your own business, you must decide what type of ownership the business will have. There are three main types of ownership arrangements. A business that is owned exclusively by one person is a **sole proprietorship**. A business owned by two or more people is a **partnership**. A business with the legal rights of a person that is independent of its owners is a **corporation**. In addition, there are alternative forms of corporations.

Sole Proprietorship

Sole proprietorships enable one person to be in control of all business aspects. Sole proprietorships may be very small businesses with just a few employees, or they may be large businesses with hundreds of employees.

Advantages The government exercises very little control over sole proprietorships, so such businesses can be established and run very simply. Accurate tax records and certain employment laws must be met, but these are usually the only forms of government regulation on a sole proprietorship. For this reason, the sole proprietorship is by far the most common form of ownership in the United States.

Disadvantages It can be difficult to raise money for a sole proprietorship. You are the only person contributing money to the business. Also, owners of sole proprietorships face a risk that owners of partnerships or corporations do not. If a sole proprietorship fails and debts remain, the entrepreneur's private assets may be taken to pay what is owed.

Partnership

Many entrepreneurs prefer to go into business with one or more partners so that they have someone with whom to share decision-making and management responsibilities.

Advantages Running a business as a partnership means that you will not have to come up with all of the capital alone. It also means that any losses the business incurs will be shared by all of the partners. Partners often offer different areas of expertise, which can strengthen the business. Like sole proprietorships, partnerships face very little government regulation.

Disadvantages Some entrepreneurs do not like partnerships because they do not want to share responsibilities and profits with other people. They fear being held legally liable for the errors of their partners. Partnerships can also lead to disagreements and can end bitterly.

Partnership Agreement When two or more entrepreneurs go into business together, they usually sign a *partnership agreement*, which sets down in writing the rights and responsibilities of each owner. It identifies the following.

1. Name of the business or partnership and names of the partners
2. Type and value of the investment each partner contributes
3. Managerial rights and responsibilities of each partner
4. Accounting methods to be used
5. Division of profits and losses among the partners
6. Salaries to be withdrawn by the partners
7. Duration of the partnership
8. Conditions under which the partnership can be dissolved
9. Distribution of assets upon dissolution of the partnership
10. Procedure for dealing with the death of a partner

NET Bookmark

A partnership arises whenever two or more people co-own a business and share in the profits and losses of the business. Access www.cengage.com/school/business/21biz and click on the link for Chapter 3. Follow the link and read the article on partnerships. Then name and describe three common types of partnerships.

www.cengage.com/school/business/21biz

GENERAL PARTNERSHIP AGREEMENT FORMING
"SUNNY SIDE UP"

By agreement made this 21st day of September, 20--, we, Ana Ortiz, Keesha Gentry, and Thomas Chase, the undersigned, all of Palm Harbor, Florida, hereby join in general partnership to conduct a food service business and mutually agree to the following terms:

1. That the partnership shall be called "Sunny Side Up" and have its principal place of business at 2013 Sand Drive, Palm Harbor, Florida, at which address books containing the full and accurate records of partnership transactions shall be kept and be accessible to any partner at any reasonable time.

2. That the partnership shall continue in operation for an indefinite time until terminated by the death of a partner or by 90 days' notice provided by one or more of the partners and indicating his, her, or their desire to withdraw. Upon such notice, an accounting shall be conducted and a division of the partnership assets made unless a partner wishes to acquire the whole business by paying a price determined by an arbitrator whose selection shall be agreed to by all three partners. Said price shall include goodwill, and the paying of same shall entitle the payor to continue the partnership business under the same name.

3. That each partner shall contribute to the partnership: $22,000 for initial working capital and the supplies and equipment.

4. That in return for the capital contribution in item 3, each partner shall receive an undivided one-third interest in the partnership and its properties.

5. That a fund of $75,000 be set up and retained from the profits of the partnership business as a reserve fund. It being agreed that this fund shall be constituted on not less than 15 percent of the monthly profits until said amount has been accumulated.

6. That the profits of the business shall be divided equally among the partners, that the losses shall be attributed according to the subsequent agreement, and that a determination of said profits and losses shall be made and profit shares paid to each partner on a monthly basis.

7. That the partnership account shall be kept in the First Florida Bank and that all withdrawals from same shall be by check bearing the signature of at least one of the partners.

8. That each partner shall devote his or her full efforts to the partnership business and shall not engage in another business without the other partners' permission.

9. That no partner shall cause to issue any commercial paper or shall enter into any agreements representing the partnership outside the normal conduct of the food service business without notice to the remaining partners and the consent of at least one other partner and further that all managerial and personnel decisions not covered by another section of this agreement shall be made with the assent of at least two of the partners.

IN AGREEMENT HERETO, WE ARE

Ana Ortiz	Keesha Gentry	Thomas Chase
Ana Ortiz	*Keesha Gentry*	*Thomas Chase*

CheckPOINT

Why are sole proprietorships the most common form of business ownership?

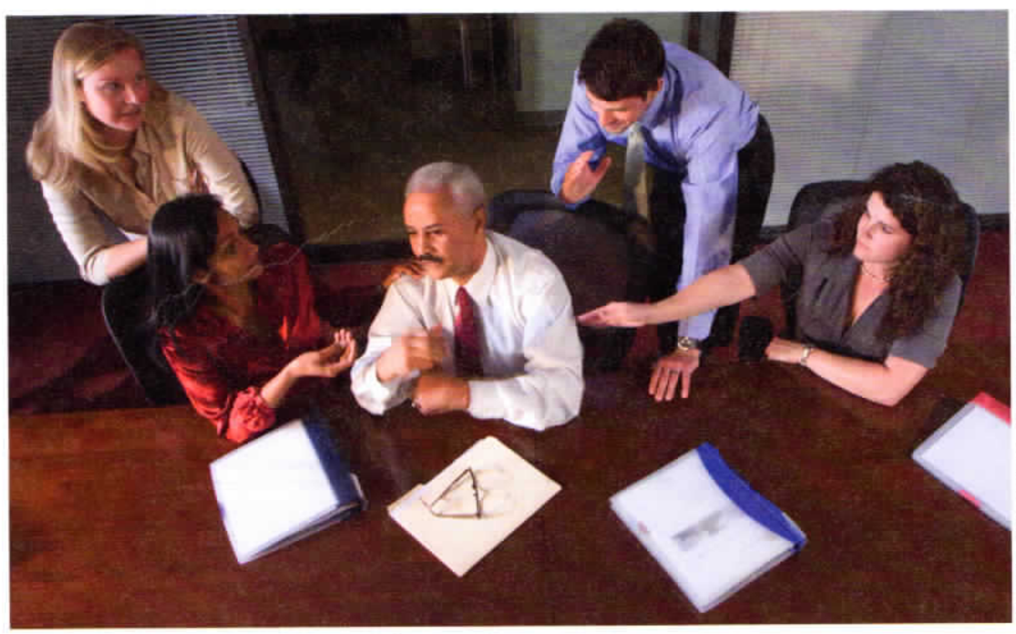
Corporation

Unlike a sole proprietorship or a partnership, a corporation is treated independently of its owners. Since a corporation has the legal rights of a person, the corporation, not the owners, pays taxes, enters into contracts, and may be held liable for negligence.

Corporation Basics

Ownership of a corporation is in the form of shares of stock. A **share of stock** is a unit of ownership in a corporation. People who own stock in the corporation are called *shareholders* or *stockholders*.

Every corporation has a **board of directors**, a group of people who meet several times a year to make important decisions affecting the company. The board of directors is responsible for electing the corporation's senior officers, determining their salaries, and setting the corporation's rules for conducting business. The board of directors also decides how much the corporation should pay in dividends. **Dividends** are distributions of profits to shareholders by corporations. The company's officers, not the board of directors, are responsible for the day-to-day management of the corporation.



What are the duties of the board of directors?

Tech Literacy

SOCIAL NETWORKING AND BUSINESS

E-mail has become a necessity for most business owners today to communicate with employees, shareholders, suppliers, and customers. Now social networking is entering the business scene. Business owners are beginning to find new and creative ways to use these sites for business promotion.

1. *Twitter* allows users to send very short messages called tweets that are no more than 140 characters long. Business owners find it a good way to keep their name in front of people who have a connection with or interest in their business. Some businesses also use it to announce special offers.
2. *LinkedIn* is a social networking site aimed specifically at business. It can be used to search for consultants and contractors. It has also become a major source for posting job openings.
3. *YouTube* is a great way to get information out to prospects and customers. You can make a short promotional video demonstrating your product or service or have current customers provide testimonials about it. A short e-mail can direct prospective customers to your YouTube video.

THINK CRITICALLY

Why are social networking sites useful in business?

Disadvantages Setting up a corporation is more complicated than setting up a sole proprietorship or a partnership. To *incorporate* a business means to set up a business as a corporation. To incorporate, you will need the assistance of a lawyer, who will help you file articles of incorporation with the state official responsible for *chartering*, or registering, corporations. Because of this, establishing a corporation can be costly. Articles of incorporation must be written which fully detail the purpose of the business. If the articles are not well written, the corporations' activities can be limited.

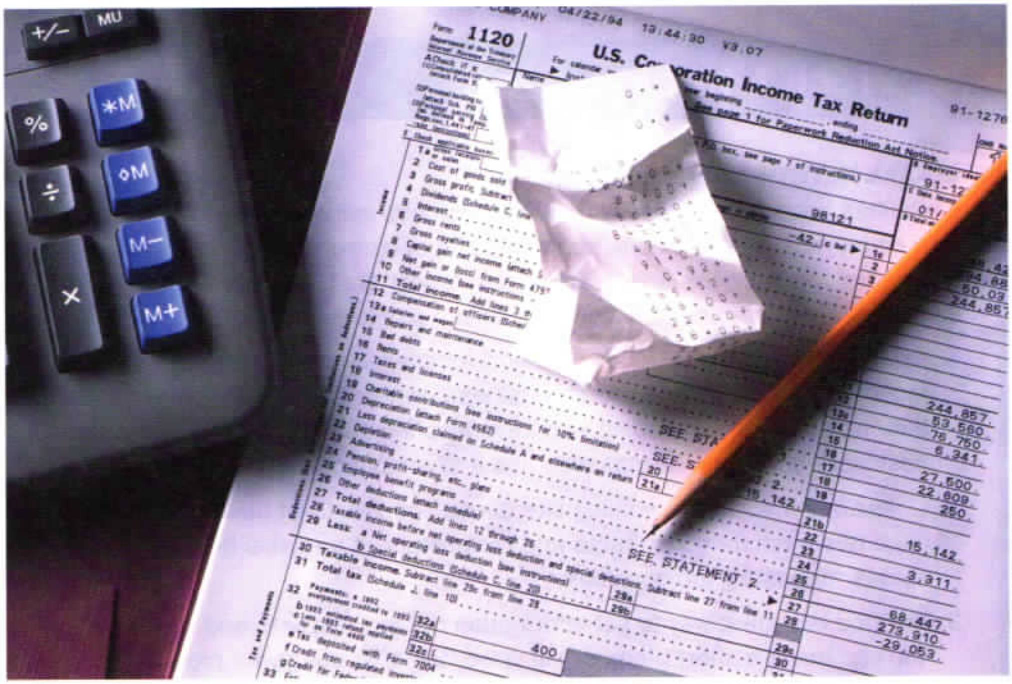
Corporations are subject to much more government regulation than are sole proprietorships or partnerships. Another drawback of incorporation is that income is taxed twice. A corporation pays taxes on its income, and shareholders pay taxes on the dividends they receive from the corporation. This means that the corporation's profits are taxed as corporate income and again as individual income. This is known as *double taxation*.

Advantages If the corporate form of ownership is complicated and costly, why do entrepreneurs set up corporations? Liability is the main reason. **Liability** is the amount owed to others. The shareholders' liability is limited to the amount they invested when they purchased company stock.

Incorporation allows businesses to raise money by selling more stock. Lenders are also more willing to lend money to corporations than to sole proprietorships or partnerships. Finally, because shareholders do not participate in the management of a corporation, the top shareholder of the company can change, through the buying and selling of stock, without disrupting the day-to-day operation of the business.

TEAMWORK

As a class, make a chart of the three legal forms of business ownership. List the advantages and disadvantages of each.



Photodisc/Getty Images

How are taxes handled for the various forms of corporations?

S Corporation

Small corporations can elect to be treated as an S corporation. An *S corporation* is a corporation organized under Subchapter S of the Internal Revenue Code whose income is taxed as a partnership. Unlike regular corporations, an S corporation is not taxed as a business. Only, the individual shareholders are taxed on the profits (dividends) they earn. S corporations must follow the same formalities and record-keeping procedures as regular corporations. They are also managed by a board of directors and officers.

Limited Liability Company

A *limited liability company (LLC)* is a legal form of business that goes further than an S corporation in providing the benefits of partnership taxation and limited personal liability for the owners of the business. The LLC is not subject to the rules for an S corporation, so it is simpler to operate. Owners of LLCs are known as members—not shareholders. Unlike shareholders, members can participate in the management of the business. The disadvantages of an LLC are that the type of businesses may be limited by state law, a single owner cannot establish an LLC, and many states limit the life of an LLC.

CheckPOINT

What is the main benefit of setting up your business as a corporation?