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Business ownership

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What is the best choice of type of ownership for your business? As an entrepreneur, you must decide which type of ownership is most appropriate. You should consider factors such as start-up costs, the amount of control you desire, the amount of personal risk you are willing to assume, and your need for assistance in business management. Table 1 summarizes the advantages and disadvantages of four types of business ownership — sole proprietorship, partnership, incorporation, and cooperative. You must be the one to decide which is best for you.

Sole proprietorship

The most common form of business ownership is the sole proprietorship, sometimes called the individual proprietorship. This business is owned by one person. It is usually operated by the owner, possibly with the help of family members or a few employees. Sole proprietorships can usually operate with very limited capital resources.

The sole proprietorship is the least complicated form of ownership and the easiest to enter and terminate. Entry requires little more than a location, expertise in the area of business considered, a source of capital, the ability to make contacts, and the desire to start your own business. Termination generally requires paying your debts and closing your doors.

What does it mean legally?

As a sole proprietor, your liability is limited to your own errors and obligations. But in case the business fails, your personal assets — including home, automobile, and other properties — are subject to claim by creditors. You can deal with the problem of unlimited personal liability to a certain extent by purchasing business liability insurance. However, as a sole proprietor you would still be personally liable for any business debts or loans because liability insurance only protects against claims arising from a business-related injury.

As a sole proprietor, you must be all things to your business — or be willing to pay for professional help. You must be willing to work long hours, establish a record-keeping system, prepare tax reports, and hire and train personnel. As sole proprietor, you must arrange any financing your business needs as well as pay your creditors. All of these abilities are seldom possessed by one person.

What about taxes?

One main advantage of a sole proprietorship is its tax advantage. Your business is not a separate tax-paying or tax-reporting unit; it is treated as part of your overall financial activities. You should keep separate records of business income, deductions, inventories, and capital acquisitions. This profit or loss is combined with other personal income for tax purposes. As the personal income tax rate is often lower than the corporate one, taxes are generally lower for the sole proprietor.

Partnership

Forming a partnership can be a challenge. Like a marriage, a partnership requires understanding, tact, and negotiation. Disagreements between partners account for a large number of business closings. No matter how well the partners know each other or how long they have been friends, the partnership cannot survive without a written agreement or contract.

Articles of co-partnership

Articles of co-partnership ensure each partner does his or her share of the work and gets a fair share of the profits. Certain items should be included in the agreement. You might want to use the following as a checklist when reviewing your partnership agreement. It should include:

- Date of the agreement.
- Names and addresses of all the partners.



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Table 1. Advantages and disadvantages of types of ownership.

Forms of ownership	Advantages	Disadvantages
Sole proprietorship	<ol style="list-style-type: none"> 1. Low start-up costs 2. Greatest freedom from regulation 3. Owner in direct control 4. Minimal working capital requirements 5. Tax advantage to small owner 6. All profits to owner 	<ol style="list-style-type: none"> 1. Unlimited liability 2. Business ceases at death of owner 3. Difficulty in raising capital
Partnership	<ol style="list-style-type: none"> 1. Ease of formation 2. Low start-up costs 3. Additional sources of venture 4. Broader management base 5. Possible tax advantage 	<ol style="list-style-type: none"> 1. Unlimited liability 2. Business may cease at death of a partner 3. Divided authority 4. Difficulty in raising additional capital 5. Difficulty in finding suitable partners
Corporation	<ol style="list-style-type: none"> 1. Limited liability 2. Specialized management 3. Transferable ownership 4. Continuous existence 5. Legal entity 6. Possible tax advantages 7. Ease of raising capital 	<ol style="list-style-type: none"> 1. Close regulation 2. Most expensive form to organize 3. Charter restrictions 4. Extensive record-keeping 5. Double taxation
Cooperative	<ol style="list-style-type: none"> 1. Smaller-than-usual capital investment 2. Divided authority 3. Possible difficulties in cancelling 4. Economical purchasing of supplies 5. Shared expenses for trade shows/exhibits 	<ol style="list-style-type: none"> 1. Some loss of independence 2. Less working capital than normally required 3. Joint decision making 4. Concern of quality control

- Nature of the business.
- Duration of the partnership.
- Managerial duties of each general partner.
- Specification of each type of limited partner. (whether silent, dormant, secret, or nominal) and the liability, if any, of each.
- Fee to be paid any nominal partner.
- Amount of investment by each partner.
- How profits and losses will be shared.
- Accounting procedures to be used.
- Salary or drawing account arrangements for each partner.
- Restraints on each partner, if any.
- How the partnership will be terminated.

The last item is extremely important. Provisions must be made to dissolve the partnership in case one partner wants to leave the business for other employment or because of illness or death. Arrangements must be made to equitably dissolve the partnership.

The articles of co-partnership should be written by a lawyer, notarized or witnessed by an uninvolved party, filed in the county clerk's office at the county courthouse, and a copy kept in a safe place. It is a contract and, therefore, legally binding. The Uniform Partnership Act, drafted by the National Conference

of Commissioners on Uniform State Laws and approved by the American Bar Association, should be consulted as a guide.

What about taxes?

You report and pay taxes on a partnership like you would in a sole proprietorship; you and your partner pay income taxes on individual shares of the profits, but no tax is paid on the partnership. You report your share of the profit earned during the tax period that ends within the year being reported (by December 31 or June 30). This is done whether or not profits are actually distributed. The rate of tax is the same as for the individual, and the income is reported on an individual 1040 form (Schedule E). A partnership return has to be filed with the IRS for information purposes only (Form 1065).

You and your partner are personally liable, including personal assets, for debts and judgments. Creditors can collect from either you or your partner — even if you did not necessarily contract the debt.

Incorporation

A corporation is by far the most structured and complicated form of business ownership. Very rarely does the new or first-time owner form a corporation. A successful sole proprietor or a partnership that wishes to expand or to remove the personal unlimited liability is most likely to move to the corporate form. Since the corporation is a creation of law, it is imper-

sonal and exists apart from the individuals who share its ownership.

A corporation must be chartered. When the state issues a charter, your firm's activities are specified. A firm incorporated as a drug store could not legally engage in manufacturing. The geographic area in which the firm can operate is limited to the state granting the charter.

If you incorporate your sole proprietorship, you can exchange the assets owned for shares of stock. This may be done tax-free if you, or you and your partner, own 80 percent of the stock, have immediate control of the corporation, and the assets are transferred solely in exchange for stock and securities in the new corporation.

Articles of incorporation

After you file the articles of incorporation with the secretary of state and pay the one-time \$60 fee, you will receive a certificate of incorporation. The following list will help you prepare your application, which needs to include:

- Specific name of your corporation (which in the United States includes the abbreviation "Inc."). The name cannot be the same as one already in use when the charter is issued.
- Specific purpose of your corporation.
- Names and addresses of the directors and incorporators. Depending on the state, one to five incorporators must reside in the state in which the application is made.
- Location of your company's main office.
- Duration of your corporation.
- Amount and kinds of capital stock issued at the outset of the operations.
- Full description of the voting rights of the stockholders.

You should also draw up a set of bylaws. The bylaws should state the regulations and limits of the corporation. This protects all the owners, present and future, from unwise or selfish decisions by the board of directors.

From the time you pay the charter fee and the certificate is issued, all agreements are made in the name of the company and not in your name. You become a stockholder who may or may not be involved in the actual operation of the business. For more information on incorporating, contact the Secretary of the State of Idaho, Statehouse Room 203, Boise, Idaho 83720, (208) 334-2300.

What about taxes?

Corporations are taxed more than sole proprietorships and partnerships. Not only must taxes be paid

by the corporation itself, but if you take a profit from the corporation, you must pay personal income tax on the profit. You may be able to forestall this "double taxation" by forming a subchapter corporation, which is ideal for new and low-income businesses. Consult an attorney before forming a subchapter corporation. With this type of ownership, your corporation may be taxed at lower rates. Regardless, corporate profits are taxed at a higher percentage or bracket than personal taxes.

Corporate tax reporting may be done in two ways:

1. The corporation is treated as a separate taxpayer and pays a corporate tax on its net income. As a shareholder you pay personal tax on salary, dividends, and interest you receive from the corporation.
2. Under the Subchapter Section of the Internal Revenue Code, the corporation reports its income or loss. As shareholder you report income on your tax return, even if you have not withdrawn money or property from the corporation. If the corporation incurs losses, you can deduct losses on your tax return.

Under the first method, anything you do not withdraw is taxed at a corporate level and then taxed again when you withdraw it. The second method avoids this.

Cooperative

A business formed by a group of people to obtain services or products more effectively and economically than they could get individually is called a cooperative. Members of the cooperative own, finance, and operate the business for mutual benefit. As a small and home-based business owner you may want to form a cooperative to overcome the barriers of limited market access due to rural isolation, limited access to sources of supply due to rural isolation (which may restrict the availability of quality supplies in economical quantities), and limited business training and skills of producers.

Cooperatives are similar to corporations except net income paid to owners/users is taxed as personal income, ownership benefits can be distributed in proportion to use, control is democratic with one vote per patron, service or product is sold at cost, and there is limited return on equity capital. All income is distributed to members on a participation basis. Therefore, cooperative organizations come under no state or federal income tax liability.

Like a sole proprietorship, partnership, or corporation, a cooperative must operate as a business with complete planning, management, and written policies. The cooperative should retain an attorney to ensure the proper legal procedures are followed in setting up the cooperative.

Remember...

Keep in mind rules and laws change. It is always wise to check with the agencies responsible for the most current information on business ownership and legal obligations.

For further reading

Consult the free publication, *Starting a Business in Idaho*, available from the Idaho Department of Commerce, 700 West State Street, Boise, ID 83720, (208) 334-2470.

To order copies of this or other University of Idaho College of Agriculture publications, contact the

University of Idaho Cooperative Extension System office in your county or write to Agricultural Publications, Idaho Street, University of Idaho, Moscow, Idaho 83843-4196 or call (208) 885-7982. Idaho residents add 5 percent sales tax.

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