



# Small Business Management: A Planning Approach

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# **PART 1**

## **The Small Business**

### **CHAPTER 2**

## **Legal Forms of Ownership**

# 2-1 Introduction

- It is important to consider what form of ownership the business will take.
- There are several organizational formats to choose from and this would determine the amount of taxes payable, legal obligations and survival of the organization
  - Proprietorship
  - Partnership (including both the general and limited forms)
  - Corporation (including both the C corporation and the S corporation)
- The tools and techniques used to operate a business are universal, however, the ways to choose and organize are not.



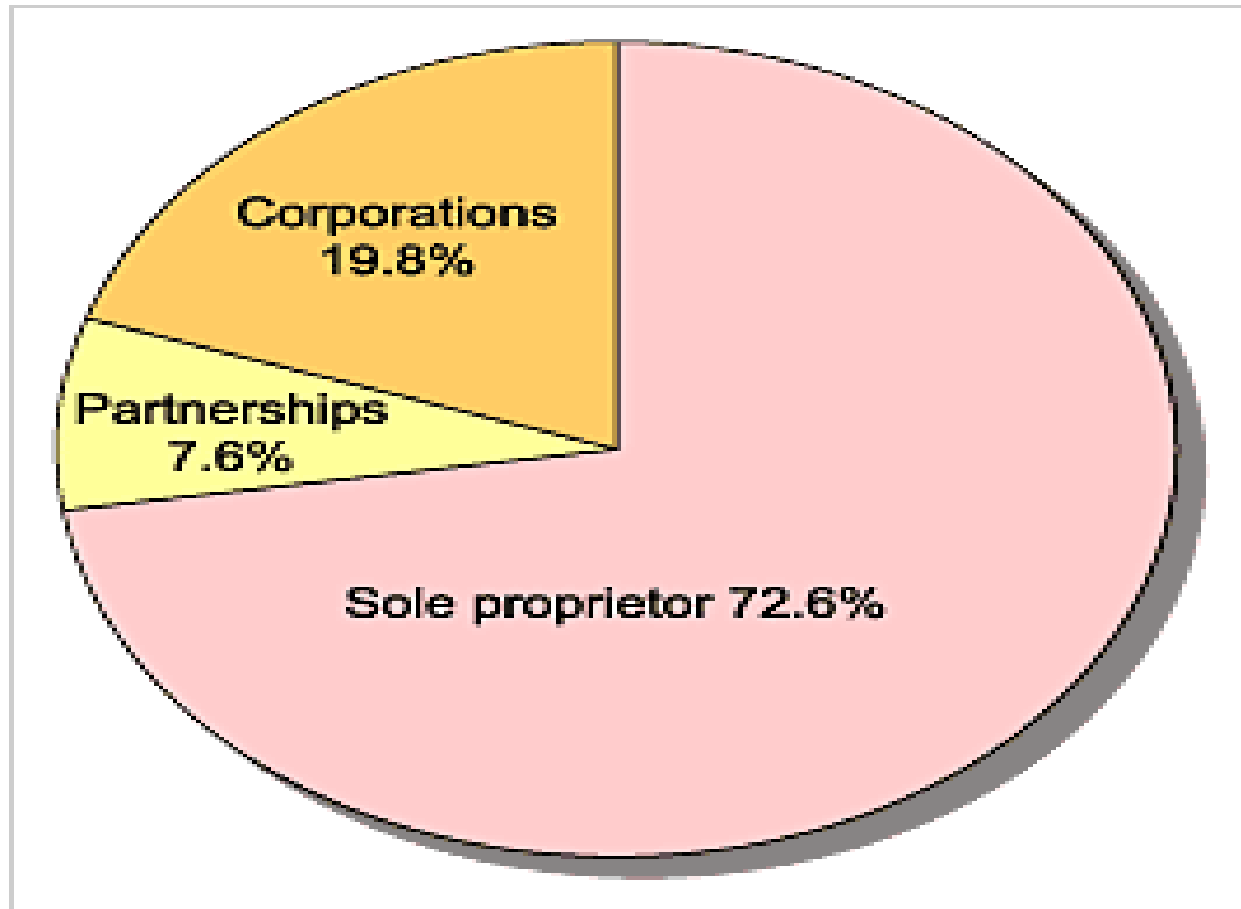
## 2-2 Sole Proprietorship\_

- An unincorporated business owned and operated by one person.
- This is the most common form of ownership, with 17.2 million single proprietorships.
- A single proprietor, receives all the profits of the business but also bears all the costs and has unlimited liability from the firm's operations.
- For a new business owner, this form of ownership is the easiest and least expensive to set up.



## 2-2 Sole Proprietorship (contd.)

Percentage of sole proprietors, partnerships, and corporations



# 2-2a Advantages of Proprietorship

- The reasons for the popularity of proprietorships are:
  - Ease of start-up
  - Profits
  - Freedom to manage as you choose
  - Few legal restrictions
  - Easy to dissolve
  - Taxes



# 2-2b Disadvantages of Proprietorship

- Some of the disadvantages of a sole proprietorship firm are:
  - Unlimited liability
  - Difficulty in raising capital
  - Maintaining the overall direction of the business
  - Demise of the firm



## 2-3 Partnership

- A partnership is an association of two or more people who carry on as co-owners of a business.
- There are two basic kinds of partnerships
  - General partnership:
    - Partners active in the operation of the business
    - Shares all responsibilities, profits, and liabilities
  - Limited partnership
    - Partner does not take active part in the management of the business
    - Has limited liability





## 2-3a Forms of Partnership

- Partnerships, are similar to proprietorships, in many ways
- Advantages of partnership firms:
  - Partnerships are not difficult to form.
  - All partners are owners and therefore there is a share in the profits.
  - All partners have the right and freedom to manage the business.
  - There are few legal restrictions.
  - The organization is easy to dissolve.
  - Partners are taxed individually and not as a business.



## 2-3a Forms of Partnership (contd.)

- Disadvantages of partnership firms:
  - Each partner is liable for the debts of the organization.
  - Raising capital can be difficult.
  - As the business grows, management becomes difficult.
  - There is limited opportunity for employees and the rights of control and ownership reside with the partners.
  - Death, imprisonment, or insanity automatically terminate the firm unless the partnership agreement states otherwise.



## 2-3b General Partnership

- All partners participate actively in operating the business.
- All partners share the responsibilities involved in running the firm.
- Unlimited liability, which increases corresponding to the expansion of the business
- The management becomes complex, as too many partners are involved in decision making.



## 2-3c Limited Partnership

- Limited partnerships are created in order to limit liability of the partners and to facilitate the contribution of capital.
- Lets partners carry on as co-owners, with certain partners having more responsibility and power than others.
- The general partners carry more liability than the limited partners, whose roles are also limited.
- The limitations of limited partners involve both liability and management obligations.



## 2-3d The Partnership Agreement

- A partnership agreement is a written document (articles of agreement) that sets forth all the terms under which the partnership is to operate.
- The partnership could be an oral agreement, but is generally not done that way.
- Writing down the terms of the partnership may eliminate future disputes.
- The agreement should spell out the status, responsibilities, and authority of each partner.
- A written partnership agreement sets forth the details and terms of the partnership for the protection of each partner.



# 2-3d The Partnership Agreement (contd.)

- Each partnership agreement contains clauses specific to the organization and its principals.
- Having a written agreement forces everyone to be specific and detailed, which remains as legal reminders of what has been approved.
- In the absence of a written agreement, terms of the Uniform Partnership Act apply.



# 2-3d The Partnership Agreement (contd.)

## Model partnership agreement

**Name of the partnership.** What have you decided to name your business?

**Purpose of the business.** Why did you create this business, and what will the business do?

**Location.** Where will the business be located physically?

**Duration of the partnership.** How long do you think the firm will operate? It is possible to have a partnership that lasts on a continuing basis (at least as long as all partners are alive) or one that is of short duration or established for a specific purpose and for time.

**Name and legal address of all partners.** Who are the partners in your business and where do they reside?

**Contribution of each partner to the business.** This spells out who contributed specific assets to the organization. Contributions may consist of cash, real estate, skills, contacts, or any other form of assets.

**Terms specifying the distribution of profits and losses.** Because the partnership income and expenses are treated as ordinary income and expenses as far as federal and state taxes are concerned, it is best to specify each partner's appropriate percentage of ownership and distribution. All partners need this protection. Shares of profits and/or losses may not be equal. Spell it out!

**Terms specifying partners' compensation.** Some partners may be paid a salary or commission because of their activity in the business. This compensation can be in addition to their share of the profits. Generally, if one partner is more active or makes a bigger contribution to the organization than other partners, that partner is entitled to additional compensation.

**Definition of profits.** Because each partner is entitled to a specific percentage of the profits, it is best to know how profits are determined: Which expenses are costs of doing business and which are personal? Obviously, the higher the business expenses, the less profit there is to be divided.

**Provisions for answering questions.** Important questions should be resolved before you begin business operation: How may a new partner be added or a current partner deleted? How will the partnership be dissolved or sold, and how will the assets be distributed?

**Provisions governing how the absence or disability of a partner will be handled.** For example, will the partnership continue? Will the salary or asset distribution remain the same? Is a disabled partner still responsible for the firm's debts?

**Provisions for altering the partnership agreement.** Nothing lasts forever. Times and circumstances change, and partnership agreements should contain provisions to accommodate change.



# 2-3e Uniform Partnership Act

- If partners lack a written partnership agreement, the Uniform Partnership Act (UPA) stipulates the rights and obligations of each of the partners engaged in the operation of an organization.
- The UPA defines a partnership as “an association of two or more persons to carry on as co-owners of a business for profit.”
- A partnership commonly includes three elements:
  - Common ownership
  - Equal sharing of profits and losses
  - The right to participate in managing partnership operations





# 2-3e Uniform Partnership (contd.)

Act

- In general, under the law, each partner has the right to do the following:
  - Share in the business's management and operation
  - Share in the business's profits
  - Receive interest on any advance made to the business
  - Receive compensation for expenses having to do with the business
  - Have full access to the partnership's books and records
  - Receive formal accounting of all business affairs



# 2-3e Uniform Partnership Act (contd.)

- Partners' obligations are:
  - Share in partnership losses
  - Work without salary, if necessary
  - Abide by majority vote of partners' decisions regarding organization operation
  - Make available to all partners all information regarding business affairs
  - Give formal accounting of all business affairs
- Other types of partnerships are:
  - Secret partner
    - An owner who takes an active role in the business but does not want to reveal his/her identity



# 2-3e Uniform Partnership Act (contd.)

- Silent partner
  - An owner who takes an active part in the business but may not be known to the public
- Dormant partner
  - An owner who plays no active role and at the same time remains unknown to the public
- Nominal partner
  - An individual who does not own the business but suggests to others by words or deeds
- Senior partner
  - A general partner who has been with the partnership a long time and owns a large share of the business
- Junior partner
  - An individual who has been with the business a short time and is not expected to assume great responsibility for major decisions



## 2-4 Corporations

- The corporate form of ownership was established to overcome problems inherent in proprietorships and partnerships.
- A corporation is an association of individuals united for a common purpose and permitted by law to use a common name and to change its members without dissolution of the association.
- The corporation carries on a business in its own name and exists as a separate legal entity.
- It can raise capital by either selling ownership (stock) or borrowing (issuing bonds).



## 2-4 Corporations (contd.)

- Ownership of the corporation is established with the issuance of shares of stock.
- Individual owners, as stockholders, have no liability for corporate debt.
- Foreign corporation, are companies which are incorporated in a different state from the one where they operate, because of favorable laws, rules, regulations, and tax benefits.



# 2-4a How to Organize a Corporation

- A corporation has to comply with state regulations that require a certificate of incorporation, or a charter, to be filed with the state's attorney general.
- Corporate charter: A legal document that sets forth information about how the corporate entity intends to operate.



# 2-4b Advantages of Corporations

- A corporation has certain advantages not open to other forms of organizations:
  - Limited liability
  - Perpetuity
  - Funding sources
  - Transfer of ownership
  - Separation of ownership and management
  - Expansion and contraction



# 2-4c Disadvantages of the Corporate Form of Ownership\_

- Disadvantages of a corporate form of ownership:
  - Cost, time and paper work
  - Taxation
  - Red tape, paperwork and regulations
  - Perils of increasing capitalization
  - Federal and state control
  - Charter restrictions





## 2-4d The S Corporation

- In a move to equalize the tax burden for all forms of organizations, in 1954 the IRS created a new tax entity, the Subchapter (S) Corporation.
- S corporation is a corporate identity treated as an individual for income tax purposes.
- In order to qualify for S corporate status, a company must meet certain requirements:
  - All stockholders must be individuals, estates, and certain trusts.
  - There can be no more than 75 stockholders.
  - The business must be a domestic corporation.
  - Nonresident aliens cannot be stockholders.
  - There can be only one class of common stock.



## 2-4d The S Corporation (contd.)

- The corporate owners must file Form 2553 with the IRS, electing to be an S Corporation.
- The advantages of S corporations:
  - Corporate taxes are avoided.
  - Shareholders are taxed on the corporate income as if it were their own and pay the appropriate individual income taxes.
  - Profits are not taxed at both the corporate and personal levels, double taxation is avoided.
  - The S corporation achieves equity of taxation with small business single proprietorships, partnerships, and corporations.
  - In cases where the business is losing money, stockholders are allowed to deduct these losses from their income on an individual basis.



## 2-4d The S Corporation (contd.)

- The disadvantages of S corporations:
  - Lower taxable income taxes for the C corporation may be lower than taxes on an individual resulting from the S corporation pass-through.
  - S corporation cannot deduct as business expenses, for tax purposes, many fringe benefits such as insurance.
  - While the typical corporation can offer a wide range of pension benefits, the S corporation's options are fewer.
  - Every state recognizes the S corporation for state tax purposes except Connecticut, the District of Columbia, Louisiana, New Hampshire, New Jersey, New York, Tennessee, Texas, and Vermont. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no state income taxes.



# 2-4e The Limited Liability Corporation

- Both S and C corporations provide limited liability.
- The corporate form of organization reduces flexibility.
- A limited liability corporation (LLC) provides flexibility and limited liability while being treated by the IRS as a partnership.
- The LLC differs from the corporate organization:
  - Corporations have stockholders, LLCs have members.
  - Shares of stock are not issued.
  - Ownership is designated in the articles of organization.



# 2-4e The Limited Liability Corporation (contd.)

- As with the corporation, liability extends only to the amount of the member's capital contribution.
- Ownership interests can be transferred only with the unanimous written consent of the other members.
- Duration of the limited liability corporation usually is 30 years.



# 2-4f The Choice: C, S, or Limited Liability Corporation?

- The choice should be based on the impact on the tax situation.
- The S corporation or LLC is useful for start-up operations or where the business is highly profitable.
- Companies do not benefit from an S corporation, where the owners receive most of the profits as salaries or benefits.
- Where benefit provisions are greater than tax savings, forming an S corporation or LLC is not beneficial to individuals and companies,
- The S corporation or LLC may not be beneficial in extremely small companies.



# 2-5 Business Firm Classification

- Literally thousands of businesses constitute the U.S. economy.
- To understand economic activity and make sense of the vast array of firms, it is necessary to classify them by type.
- Trends describing viability of each sector and its importance to the economy as a whole can be examined.
- Analysis of these trends and identification of business classification also aid in choosing a job or career.



# 2-5a North American Industry Classification System

- The North American Industry Classification System (NAICS) was developed to provide comparable statistics across the three countries covered under the North American Free Trade Agreement (NAFTA):
  - United States
  - Canada
  - Mexico
- The new classification system takes into account the “growth of service industries and developments in high technology.”





# 2-5a North American Industry Classification System (contd.)

- Prior to NAICS adoption by the Office of Management and Budget (OMB) in 1997, businesses were classified by Standard Industry Classification (SIC) codes.
- SIC, developed in the 1930s, broke down business activities into four major classifications:
  - Retail
  - Wholesale
  - Service
  - Manufacturing



## 2-5b NAICS Benefits

- The NAICS groups the economy into 20 sectors, unlike the SIC, which has 11.
- Only 5 of the 20 divisions focus on production, while 15 are concerned with services.
- 350 new businesses are recognized.
- To allow greater flexibility, the NAICS uses a six-digit coding system.

