

# Types of Businesses

This reading is adapted from *Economics: Principles in Action* by Arthur O'Sullivan and Steven M. Sheffrin (Upper Saddle River, New Jersey: Pearson Prentice Hall, 2005). I made a few changes to enhance readability and to make the examples clearer and more relevant.

If land, labor, and capital are the essential ingredients for creating all goods and services, who pulls these resources together? The answer is **entrepreneurs**. Entrepreneurs... decide how to combine land, labor, and capital resources to create new goods and services. They are the individuals who take risks to develop original ideas, start business, create new industries, and fuel economic growth....

Entrepreneurs must make many decisions as they start up new businesses. One of the first decisions they face is what form of business organization best serves their interests. A business organization is an establishment formed to carry on commercial enterprise. In other words, a business organization is a company or firm.

## Sole Proprietorships

A **sole proprietorship** is a business owned and managed by a single individual. That person earns all of the firm's profits and is responsible for all of the firm's debts. This type of firm is by far the most popular in the United States. According to the Internal Revenue Service (IRS), about 75% of all business are sole proprietorships. Most sole proprietorships are small, however. All together they generate only about 6 percent of all United States sales.

Many types of businesses can flourish as sole proprietorships. [Look around Scarsdale. Chances are good that many of the small businesses in the village are sole proprietorships.]

## Advantages of Sole Proprietorships

While you need to do more than just hang out a sign to start your business, a sole proprietorship is simple to establish. It also offers the owner numerous advantages.

### Ease of Start-Up

Easy start-up is one of the main advantages of the sole proprietorship. With just a small amount of paperwork and legal expense, just about anyone can start one.

To start a new business, a sole proprietor must meet a small number of government requirements, which can vary from city to city and state to state. Sole proprietors typically must obtain a business license, which is an authorization from local government. Some businesses, such as doctors, barbers, and day-care providers, may also need a special state license to engage in that line of work. Registering a name and obtaining a certificate of occupancy to use a building (assuming the business will not be run out of the entrepreneur's home) are other common requirements.

## Few Regulations

A proprietorship is the least-regulated form of business organization. Even the smallest business, however, is subject to some regulation, especially industry-specific regulations. For example, a food business is subject to health codes.

Sole proprietorships may also be subject to local zoning laws. Cities and towns often designate separate areas, or zones, for residential use and for business. Zoning laws may prohibit sole proprietors from operating business out of their homes. [Scarsdale has particularly stringent zoning laws because people want to maintain the quiet, residential character of their neighborhoods.]

Otherwise, these small businesses face few legal requirements. Because they require little legal paperwork, sole proprietorships are usually the least expensive form of ownership to establish.

## Sole Receiver of Profit

A major advantage of the sole proprietorship is that the owner gets to keep all profits after paying income taxes. Potential profits motivate many people to start their own businesses. If the business succeeds, the owner does not have to share the success with anyone else.

## Full Control

Another advantage of sole proprietorships is that sole proprietors can run their businesses as they wish. This means that they can respond quickly to changes in the marketplace. Such a degree of freedom appeals to entrepreneurs. Fast, flexible decision making allows sole proprietorships to take full advantage of sudden opportunities.

## Easy to Discontinue

If sole proprietors decide to stop operations and do something else for a living, they can do so easily. They must, of course, pay all debts and other obligations like taxes, but they do not have to meet any other legal obligations to stop doing business.

## Disadvantages of Sole Proprietorships

As with everything else, there are trade-offs with sole proprietorships. The independence of a sole proprietor comes with a high degree of responsibility.

### Unlimited Personal Liability

The biggest disadvantage of sole proprietorship is unlimited personal liability. **Liability** is the legally bound obligation to pay debts. Sole proprietors are fully and personally responsible for all their business debts. If the business fails, the owner may have to sell personal property to cover any outstanding obligations.

For example, let's say you took out a loan to buy several high-powered computers which you used to start a website-design business. Even if you don't make enough money to keep the business going you still must repay the loan for the computers. Business debts can ruin a sole proprietor's personal finances

## Limited Access to Resources

If your web design business takes off and grows quickly, you might need to expand your business by buying more computers or hiring some help. As a sole proprietor, you may have to expand by paying for the equipment out of your own pocket. This is because banks are sometimes unwilling to offer financing in the early days of a business. Many small business owners use all of their available savings and other personal resources to start up their businesses. This makes it difficult or impossible for them to expand quickly.

Physical capital may not be the only resource in short supply. Human capital may be lacking, too. A sole proprietor, no matter how ambitious, may lack some of the skills necessary to run a business successfully. All individuals have strengths and weaknesses. Some aspects of your business may suffer if your skills don't match the needs of the business. For example, you may be great at web design, but not at bookkeeping and accounting. You may be a master at creating clever, memorable web pages, but hate calling people on the phone to ask them to hire you.

As a sole proprietor, you may have to turn down work because you simply don't have enough hours in the day or enough workers to keep up with demand. A small business often presents its owner with too many demands, and that can be exhausting both personally and financially.

## Lack of Permanence

A sole proprietorship has a limited life. If a sole proprietor dies or closes shop because of retirement, illness, loss of interest in the business, or for any other reason, the business simply ceases to exist.

Sole proprietorships often have trouble finding and keeping good employees. Small businesses generally cannot offer the security and advancement opportunities that many employees look for in a job. In addition, many sole proprietorships are able to offer employees little in the way of **fringe benefits**. Fringe benefits are payments to employees other than wages or salaries, such as paid vacation, retirement pay, and health insurance. Lack of experienced employees can hurt a business. Once again, the flip side of total control is total responsibility: a sole proprietor cannot count on anyone else to maintain the business.

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## Partnerships

A partnership is a business organization owned by two or more persons who agree on a specific division of responsibilities and profits. In the United States, partnerships account for about 7 percent of all businesses. They generate about 5 percent of all sales and about 10 percent of all income.

## Types of Partnerships

Partnerships fall into three categories: general partnerships, limited partnerships, and limited liability partnerships. Each divides responsibility and liability differently.

### General Partnership

The most common type of partnership is the **general partnership**. Partners in a general partnership share equally in both responsibility and liability. **Liability** is the legally bound obligation to pay debts. Partners are fully and personally responsible for all their business debts. If the business fails, the owners may have to sell personal property to cover any outstanding obligations. Doctors, accountants, and other professionals often form partnerships with colleagues. Small retail stores, farms, construction companies, and family businesses often form partnerships as well.

### Limited Partnership

In a limited partnership, only one partner is required to be a general partner, in charge of making day-to-day decisions for the business. Other partners are limited partners. They do not actively manage the business, and can lose only the amount of their initial investment.

## Limited Liability Partnerships

The **limited liability partnership (LLP)** is a newer type of partnership recognized by many states. In this type of partnership, all partners have limited liability. This protects partners from personal liability in certain situations, such as when losses stem from another partner's mistakes. Not all types of businesses are allowed to register as limited liability partnerships. Most states allow professionals such as attorneys, physicians, dentists, and accountants to register as LLPs.

# Advantages of Partnerships

Partnerships are easy to establish and are subject to few government regulations. They provide entrepreneurs with a number of advantages.

## Ease of Start-Up

Partnerships are easy and inexpensive to establish. The law does not require a written partnership agreement. Most small business experts, however, advise partners to work with an attorney to develop a partnership agreement. This legal document spells out each partner's rights and responsibilities. It outlines how partners will share profits or losses. Partnership agreements may also address other details, such as the ways new partners can join the firm, duration of the partnership, and tax responsibilities.

Partnerships are subject to little government regulation. The government does not dictate how partnerships conduct business. Partners can distribute profits as they wish, as long as they abide by the partnership agreement or state laws on partnerships.

## Shared Decision Making and Specialization

In a business owned by one person, the individual owner has the sole burden of making all the business decisions. In a partnership, the responsibility for the business may be shared. An individually owned business required to owner to wear many hats, some of which might not fit very well. In a successful partnership however, each partner brings different strengths and skills to the business.

## Larger Pool of Capital

Each partner's assets, or money and other valuables, improve the firm's ability to borrow funds for operations or expansion. Partnership agreements may allow firms to add limited partners to raise funds.

Partnerships offer more advantages to employees, enabling them to attract and keep talented employees more easily than businesses with only one owner. Graduates from top accounting schools, for example, often seek jobs with large and prestigious accounting LLPs, hoping to become partners themselves someday. Many law school graduates similarly seek out successful partnerships for employment.

## Taxation

Partnerships, like individually owned businesses, are not subject to any special taxes. Partners pay taxes on their share of the income that the partnership generates. The business itself, however, does not have to pay taxes.

# Disadvantages of Partnerships

Partnerships also present some disadvantages. Many of the disadvantages of individually owned businesses are present in partnerships. Limited liability partnerships have fewer disadvantages than partnerships with general partners. All partnerships, however, have the potential for conflict.

## Unlimited Liability

Unless the partnership is an LLP, at least one partner has **unlimited liability**. As in an individually owned business, any general partner could lose everything, including personal property, in paying the firm's debts. Limited partners do not face the same threat. They can lose only their investment.

In a partnership, each general partner is bound by the acts of all other general partners. If one partner's actions cause the firm losses, then all of the general partners suffer. If one doctor in a partnership is sued for malpractice, all of the doctors in the partnership stand to lose. General partners do not enjoy absolute control over the firm's actions like people who are the only owners of their own business do. The risk from other people's actions means that people must choose their business partners carefully.

## Potential for Conflict

As in any close relationship, partnerships have the potential for conflict. Partnership agreements address technical aspects of the business, such as profit and loss. Many important considerations exist outside these legal guidelines, however. Partners need to ensure that they agree about work habits, goals, management styles, ethics, and general business philosophies. Still, friction between partners often arises and can be difficult to resolve. Many partnerships dissolve because of interpersonal conflicts. Partners must learn to communicate openly and find ways to resolve conflicts.

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## Corporations

Businesses often rely on investment to expand operations. One way for a business to increase investment is to form a **corporation**. A corporation can grow even larger by combining with other corporations. Some corporations are so large that they do business all over the world.

The most complex form of business organization is the corporation. A corporation is a legal entity, or being, owned by individual stockholders, each of whom faces limited liability for the firm's debts. Stockholders own **stock**, a certificate of ownership in a corporation. In other words, if you own stock in a corporation, you are a part-owner of that corporation. If a corporation issues 1,000 shares of stock, and you purchase 1 share, you own 1/1000<sup>th</sup> of the company.

Corporations differ from sole proprietorships, which have no identity beyond that of the owners. A corporation is defined as an "entity" because it has a legal identity separate from those of its owners. Legally, it is regarded much like an individual. A corporation pays taxes, may engage in business, make contracts, sue other parties, and get sued by others.

In the United States, corporations account for about 20 percent of all businesses, yet sell about 90 percent of all products sold in the nation. They generate about 70 percent of the net income earned in the nation. Because of the advantages of corporations, most large business firms do incorporate. Supermarkets, high-tech companies, and machinery manufacturers are just some of the types of firms that usually form corporations. Corporations' profits are about ten percent of their income.<sup>1</sup>

### Types of Corporations

Some corporations issue stock only to a few people, often family members. These stockholders rarely trade their stock, but pass it on within families. Such corporations are called closely held corporations. They are also known as **privately held corporations**.

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<sup>1</sup> I'm not an expert, but it seems to me that this is a big generalization. Sometime firms lose money, and have no profits. Other times they earn much larger returns, sometimes called "windfall profits."

A **publicly held corporation**, on the other hand, has many shareholders who can buy or sell stock on the open market. Stocks are bought and sold at financial markets called stock exchanges, such as the New York Stock Exchange.

## Corporate Structure

While the exact organization varies from firm to firm, all corporations have the same basic structure. Corporation owners—the stockholders—elect a board of directors. The board of directors makes all the major decisions of the corporation. It appoints corporate officers, who run the corporation and oversee production. Corporate officers, in turn, hire managers and employees, who work in various departments like finance, sales, research, marketing, and production.

# Advantages of Incorporation

Incorporation, or forming a corporation, offers advantages to both the individual owners, or stockholders, and to the corporation itself. These include

- limited liability for owners
- transferable ownership
- ability to attract capital
- long life

## Advantages for Stockholders

The primary reason that entrepreneurs choose to incorporate, or form a corporation, is to gain the benefit of limited liability. Individual investors do not carry responsibility for the corporation's actions. They can lose only the amount of money they have invested in the business.

Corporations usually also provide stockholders with more flexibility than other ownership forms. Shares of stock are transferable, which means that stockholders can sell their stocks to others and get money in return.

## Advantages for the Corporation

The corporate structure also presents advantages for the firm itself. Corporations have more potential for growth than other business forms. By selling shares on the stock market, corporations can raise money to purchase capital. A corporation can offer as many shares of stock as its corporate charter allows. As long as investors have confidence in the firm's success, companies should be able to sell stock fairly easily.

Corporations can also raise money by borrowing it. They do this by selling bonds. A **bond** is a formal contract to repay borrowed money with interest at fixed intervals. [It is a kind of IOU.] Because ownership is separate from the running of the firm, corporation owners—that is, stockholders—do not need any special managerial skills. Instead, the corporation can hire various experts—the best financial analysts, the best engineers, and so forth—to create and market the best services or goods possible.

Corporations also have the advantage of long life. Unlike a business owned by one person, the company does not end with the death of an owner. Because stock is transferable, that is, it can be bought and sold, corporations are able to exist longer than simple businesses. Unless it



has state in advance a specific termination date, the corporation can continue doing business indefinitely.

## Disadvantages of Incorporation

Corporations are not without their disadvantages. These include

- expense and difficulty of start-up
- double taxation
- potential loss of control by the founders
- more legal requirements and regulations

### Difficulty and Expense of Start-Up

Corporate charters can be difficult, expensive, and time consuming to establish. Though most states allow people to form corporations without legal help, few experts would recommend this cheaper shortcut. Applications are complex and confusing.

Firms that wish to incorporate must first file for a state license known as a **certificate of incorporation**, or corporate charter. Once state officials review and approve the application, they grant a corporate charter. Then the corporation may organize itself to produce and sell a good or service.

### Double Taxation

The law considers corporations legal entities separate from their owners. Corporations, therefore, must pay taxes on their income.

Profit is a form of income. When stockholders receive income from the corporation in the form of **dividends**—the portion of corporate profits paid out to stockholders—the stockholders must pay personal income tax on those dividends. This **double taxation** keeps many firms from incorporating.

When stockholders sell their shares, they must pay a special tax, called a capital gains tax, if they have made a profit. In 2003, Congress reduced double taxation by lowering the dividend and capital gains tax rates to 15 percent.

### Loss of Control

Unlike the single owner of a small business, the original owners of a corporation often lose control of the company. Managers and boards of directors, not owners, manage corporations. These professional managers do not always act in the owners' best interests. They might be more interested in protecting their own jobs or salaries today than in making difficult decisions that would benefit the firm tomorrow.

### More Regulation

Corporations also face more regulations than other kinds of business organizations. Corporations must hold annual meetings for shareholders and keep careful records of all business transactions. Publicly held corporations are required to file quarterly and annual reports to the Securities and Exchange Commission (SEC). The SEC is a federal agency that regulates the stock market.

### Assignment

1. Teach each other about the three different types of business. Don't just list the advantages and disadvantages; make sure to explain them.
2. Define the key terms. (Note: everyone has the opening section on entrepreneurs.)
3. For each example below, determine which type of business the owner(s) of the enterprise should use, and say why that choice is the correct one.
  - a. Independent bookstore
  - b. Wine importer
  - c. Steel manufacturer
  - d. Software company
  - e. Law firm
  - f. Landscaping
4. If you had unlimited resources, which type of business would you want to start? Why?