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Forms of Business Organizations

Although numerous and diverse, the legal forms of business organization fall into three categories: the sole proprietorship, the partnership, and the corporation.

Sole Proprietorship:

The **sole proprietorship** is a business owned by a single individual who is entitled to all the firm's profits and who is also responsible for the entire firm's **debt**, that is, what the firm owes. In effect, there is no separation between the business and the owner when it comes to debts or being sued. If a sole proprietor is sued, he or she can lose not only all they invested in the proprietorship, but also all their personal assets. Sole proprietorships are often used in the initial stages of a firm's life. This in part is because forming a sole proprietorship is very easy; there are no forms to file and no partners to consult—the founder of the business is the sole owner.

However, these organizations typically have limited access to outside sources of financing. The owners of a sole proprietorship typically raise money by investing their own funds and by borrowing from a bank. However, since there is no difference between the sole proprietor and the business he or she runs, there is no difference between personal borrowing and business borrowing. The owner of the business is personally liable for the debts of that business. In addition to banks, personal loans from friends and family are important sources of financing.

Partnership:

A **general partnership** is an association of two or more persons who come together as co-owners for the purpose of operating a business for profit. Just as with the sole proprietorship, there is no separation between the general partnership and its owners with respect to debts or being sued. Its primary point of distinction from a sole proprietorship is that the **partnership** has more than one owner. The profits of the partnership are taxed to the partners as personal income.

An important advantage of the partnership is that it provides access to **equity**, or ownership, as well as financing from multiple owners in return for partnership **shares**, or units of ownership.

In **limited partnerships**, there are two classes of partners: general and limited. The **general partner** actually runs the business and faces unlimited liability for the firm's debts, while the **limited partner** is only liable up to the amount the limited partner invested. The life of the partnership, like the sole proprietorship, is tied to the life of the general partner. In addition, it is difficult to transfer ownership of the general partner's interest in the business—this generally requires the formation of a new partnership. However, the limited partner's shares can be transferred to another owner without the need to dissolve the partnership, although finding a buyer may be difficult.

Corporation:

If very large sums of money are needed to build a business, then the typical organizational form chosen is the **corporation**. As early as 1819, U.S. Supreme Court Chief Justice John Marshall set forth the legal definition of a corporation as "an artificial being, invisible, intangible, and existing only in the contemplation of law." The corporation legally functions separately and apart from its owners (the **shareholders**, also referred to as the **stockholders**). As such, the corporation can individually sue and be sued, purchase, sell, or own property, and its personnel are subject to criminal punishment for crimes committed in the name of the corporation.

There are three primary advantages of this separate legal status. First, the owners' liability is confined to the amount of their investment in the company. In other words, if the corporation goes under, the owners can only lose their investment. This is an extremely important advantage of a corporation. After all, would you be willing to invest in USAir if you would be held liable if one of its planes crashed? The second advantage of separate legal status for the corporation is that the life of the business is not tied to the status of the investors. The death or withdrawal of an investor does not affect the continuity of the corporation. The management continues to run the corporation when the ownership shares are sold or when they are passed on through inheritance. For example, the inventor Thomas Edison founded General Electric (GE) over a century ago. Edison died in 1931, but the corporation lives on. Finally, these two advantages result in a third advantage, the ease of raising capital. It is much easier to convince investors to put their money in a corporation knowing that the most they can lose is what they invest, and that they can easily sell their stock if they so wish.

The corporation is legally owned by its current set of stockholders, or owners, who elect a board of directors. The directors then appoint management who are responsible for determining the firm's direction and policies. Although even very small firms can be organized as corporations, most often larger firms that need to raise large sums of money for investment and expansion use this organizational form.

One of the drawbacks of the corporate form is the double taxation of earnings that are paid out in the form of **dividends**. When a corporation earns a profit, it pays taxes on that profit (the first taxation of earnings) and pays some of that profit back to the shareholders in the form of dividends. Then the shareholders pay personal income taxes on those dividends (the second taxation of earnings). In contrast, the earnings of proprietorships and partnerships are not subject to double taxation. Needless to say, this is a major disadvantage of corporations.

When entrepreneurs and small business owners want to expand, they face a tradeoff between the benefits of the corporate form and the potential loss of control and higher taxes that accompany it. For this reason, an attractive alternative to the corporation for such a small business is the **limited liability company (LLC)**, a cross between a partnership and a corporation.

An LLC combines the tax benefits of a partnership (no double taxation of earnings) with the limited liability benefit of a corporation (the owners' liability is limited to what they invested).

Thus, unlike a proprietorship or partnership, there is a separation between the LLC and the owners with respect to debts or being sued. As a result, the most a limited partner can lose is what he or she invested. Since LLCs operate under state laws, both the states and the IRS have rules for what qualifies as an LLC, and different states have different rules. The bottom line is that if an LLC looks too much like a corporation, it will be taxed as one.

How Does Finance Fit into the Firm's Organizational Structure?:

Finance is intimately woven into any aspect of the business that involves the payment or receipt of money in the future. For this reason it is important that everyone in a business have a good working knowledge of the basic principles of finance. However, within a large business organization, the responsibility for managing the firm's financial affairs falls to the firm's Chief Financial Officer (CFO).

(CEO) and is responsible for overseeing the firm's finance-related activities. Typically, both a treasurer and controller serve under the CFO, although in a small firm the same person may fulfill both roles. The treasurer generally handles the firm's financing activities. These include managing its cash and credit, exercising control over the firm's major spending decisions, raising money, developing financial plans, and managing any foreign currency the firm receives. The firm's controller is responsible for managing the firm's accounting duties, which include producing financial statements, paying taxes, and gathering and monitoring data that the firm's executives need to oversee its financial well-being.