

Business Firms

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Let's imagine for a moment you decide to go into farming. You know you want a herd of cows, some land and equipment, and you want to run this as a profitable business. For some people, this is as simple as inheriting their parents' farm. Let's imagine for a moment that you do not have this option. You have to start from scratch to begin a farm. Where would you begin?

One of the first choices you would have to make is what your farm's **legal structure** will be. A legal structure is simply the type of business for your farm. In this case, you would have three choices –

1. Single (sole) proprietorship
2. A partnership
3. A corporation

Some farms are pretty simple. You may already fall into one of these categories based on your previous experiences. For example, if you bought and sold cattle for the county fair project, you would be a sole proprietor.

A **sole proprietorship** is a company or organization that is owned, and usually managed by one person. This happens to be the most common type of business in the country; 73% of US businesses are sole proprietorships. Sole proprietorships usually also tend to be very small. While 73% of businesses are owned by a single person, they only account for 5% of the total economic activity!

A sole proprietor has complete control over their business. There is no one else to report to, and no one else owns a share of the business. This can be good – it means you get to keep all of the money you make. It can also be risky, as you have unlimited liability. If you can't pay your bills, a bankruptcy court can say that you have to sell your house or your car to pay your debts.

Let's imagine for a moment that you don't think you'll be able to run this farm by yourself. You still have another job, and you just don't think you have the time to run this business on your own. In addition, you don't think you'll have enough money to cover your startup costs. After all, land, equipment, and animals are all very expensive to pay for up front! You might also want someone with expertise in areas you don't have. For example, if you're great with animals but are a terrible mechanic, you might want to find someone who is good with engines and repairs.

Let's imagine that you have found a friend who wants a farm but is facing similar circumstances. Let's say your friend's name is Larry. You and Larry decide that it might be best to combine your resources and go into farming together. This would be a **partnership**. You are co-owners, sharing the costs and the profits from your farm. Partnerships are risky too. You have to really trust your partner. Plus, you have to decide how much of the profits each of you will get. Did you each invest equally? Does each of you contribute equally? If not, how do you decide who gets what percentage of each month's paycheck?

Why So Many Kinds of Firms?

Why would we need sole proprietorships, partnerships, and three different kinds of corporations? Why not just have one kind of business model?

Different types of firms offer different advantages to a wide variety of businesses. Depending on your business and personal needs, one type of firm offers the greatest number of advantages.

You would never need to find 50 investors to start a lawn mowing company...you could just do it yourself. However, if you wanted to be competitive as a machinery manufacturer, you would need immense amounts of money and capital. This means that you would have to find investors to fund your work.

No business is exactly alike, and because of the wide variety of businesses in America, there are also many different needs. Because of this, different kinds of firms exist.

Sole proprietorships have many advantages...easy to start, little regulation, complete control. However, be prepared for long hours, lots of risk, and complete liability.

There are several advantages to sole proprietorships and partnerships. Sole proprietorships are easy to start, you do not have to register with and be approved by the government (except for maybe a permit), and the owner has complete control over management and business decisions. Sole proprietors can choose what they sell, when they sell it, and how much they'll charge. Finally, the only taxes a sole proprietor pays are on the income they make with the company, and there is little government oversight or regulation for single owners of businesses.

For partnerships, some advantages are that you reduce your costs and risks by sharing them with someone else. Like a sole proprietorship, you don't have to register with the government and you pay taxes only on your income. Legal aspects are pretty simple, and government restrictions are pretty minimal. You also increase your sets of skills by having two people on the job (two heads are better than one). For example, one of you may be really good at selling a product and the other might be really good at producing a product.

Both sole proprietorships and partnerships benefit from being easy to set up, are rather simple to manage, and are relatively free from government oversight. However, there are disadvantages. The biggest disadvantage of each is that each has unlimited liability. If your business fails, your personal assets can be seized to pay off your debts. This means that your house, your car, and almost anything you own are fair game if you go bankrupt. The time, energy, and monetary commitments are also the greatest of all the business models. Some business owners spend little time outside their businesses. They may rarely get weekends off (especially in farming), and the success of their business is directly tied to their performance at their job.

In both the sole proprietorship and the partnership, you need to have strong, well developed business skills. You need to have a keen understanding of economics, marketing, and management. You have to have a strong comprehension of tax codes, leadership, and public relations. Finally, in both types of businesses, there is very limited potential for growth unless you change your business model.

Partnerships also tend to run into issues of how to fairly divide management, profits, and labor. If your partner is the mechanical expert and you are the sales expert, what happens when there are lots of sales but few mechanical problems? Do they become a salesperson too? Or do they take a week off? Would this affect their paycheck? Often business partners think that they are doing more than their partner or partners, and rifts begin to form in their business relationship. Often well-written partnership agreements are needed addressing issues such as contributions of time and labor, management responsibilities, personal responsibilities, profit and loss sharing, legal restrictions, and on how

Partnerships have a number of benefits – split workloads, increased expertise, reduced risk, and more resources. However, partnerships often fail if the partners have disagreements or can't evenly split the responsibilities. Partnerships also have full liability if the business fails.

to handle personal grievances.

Because of these disadvantages, other business models exist. A **Corporation** is a business owned by many people but is treated legally as if the business itself was a single person. A corporation is a **legal entity** – it is separate from the people who own it. The corporation can own things such as property or capital without the owners of the corporation owning those same things. A corporation can pay taxes, make contracts, sue and be sued. It is almost like creating a new person, and in a legal sense it is treated very much in this way by the government and other businesses. The major advantage of a corporation is that it provides protection for business owners from legal or tax problems. Personal assets cannot be seized if the company fails; the only loss is the individual's investment in the company.

To form a corporation, you would have to sell **stock**. Stock is basically a share of the ownership of a business. The people who own stock are called stockholders, and each stockholder has only one vote for each share of stock. This means that if you own 50% of the stock in a company, you get to make 50% of the votes. This stock has to be made publicly available; many corporations do this through agencies such as the New York Stock Exchange (NYSE).

Corporations have many advantages. Selling stock allows more money for investments and growth of a company. Most if not all large companies are corporations for this reason. Liability is limited, meaning if the corporation fails, your personal assets cannot be seized. Corporations have life beyond that of the owners. If a sole proprietor dies, the business dies too. Corporations continue to exist so long as people invest in them. Ownership change is also easy compared to a partnership or sole proprietorship. Finally, owners of a corporation do not have to devote the time, energy, and resources to their kind of business that sole proprietors and partners have to.

If you need a lot of funding to begin a company, or if you need to be very large to be competitive, forming a corporation can be a necessary choice. It offers financial protection to the owners and allows for economies of scale. However, corporations are also difficult to form, complicated to control, and subject to double-taxation by the government. A Board of Directors is necessary to run the company as well.

This is not to say there are not disadvantages. Unlike sole proprietors and partners, corporations are difficult to get started and require immense amounts of paperwork and government approval. Ending a corporation is also quite difficult and expensive. Corporations are less able to quickly respond to market changes because of the numerous owners. In a corporation, no single person has complete control, and guiding this kind of business requires complex organizational approaches.

Because a corporation has so many owners, it is subject to many more legal restrictions. The first of these restrictions is that any corporation must seek and obtain a legal charter from its state government before it can do any business. Once approved, corporations must form and elect a **Board of Directors**. A BOD makes the governing decisions for the company. While the stockholders own the company, the BOD is in control of it.

A Board of Directors has liability for the success of the company. Depending on the type of corporation, this liability can be limited or unlimited. Whether or not a board of directors is liable if a business fails is determined by two characteristics of responsibility:

1. **Duty of Loyalty** – did the BOD do everything in the best interests of the company? For example, did the CEO of Coca Cola join the board of Pepsi just to bring that company down?
2. **Duty of Care** – did the BOD make all their decisions on an informed and engaged basis? Did the BOD actively seek to analyze their information, and were they diligent in always doing the right thing? Or were they

negligent, failing to meet key responsibilities? Did they miss key pieces of information, or did they fail to investigate the finances of their company. If a business fails because the board of directors did not do their job, the stockholders can sue their board.

Businesses fail for many reasons. Sometimes these circumstances are beyond the control of the board of directors. For example, if the price of milk skyrockets, a cheese company probably will lose money. Other times, the BOD is responsible for the failing of a business. For example, in the case of the corporation Enron, the board actively deceived their shareholders about the value of their stock. When this was revealed, the company went bankrupt and the CEO and Board of Enron were prosecuted.

A key responsibility of a Board of Directors is to appoint a business manager or Chief Executive Officer (CEO) to run the corporation's day-to-day needs. The BOD usually meets once per month at most. The daily needs of a business, such as hiring and firing, financial decisions, and other management issues are controlled by a CEO who reports to the BOD. A key responsibility for any board is to hire a competent and effective CEO, or to remove a CEO who fails to do their job.

There are three different kinds of corporations. A **Subchapter C¹** is a regular corporation that sells its stock to investors. If this kind of company does well, it will pay dividends on stock. This means that shareholders will get money from the company on the basis of how much stock they own. The board will determine how much money this should be based on their business financial needs. If no profit was made, a good board will decide not to pay dividends. This may mean that the value of the stock falls; in other words, fewer people will want to buy shares of that stock because dividends were not paid. Demand will decrease and the price paid for a share of stock will fall. However, if a corporation pays dividends when it cannot afford to, the business can fail. A board of directors must carefully weigh these advantages and disadvantages. In a Subchapter C, policy decisions are made by the stockholders and the board of directors.

A **Subchapter S** is typically a small business or family corporation. It has the characteristics of a corporation but is taxed like a sole proprietorship or a partnership. The advantage of a Subchapter S over either a sole proprietorship or a partnership is that unlike the other two, a Subchapter S has limited liability. The downside is that a Subchapter S has to register with the government and is subject to more oversight and regulation.

Regular Subchapter C corporations are often double-taxed, while an advantage of Subchapter S corporations is that they are not. This means that a Subchapter C has to first pay taxes on the profits of a firm, and then pay taxes on the dividends shareholders receive. This is called "double-taxing" because some of the taxed profits are what go back to the shareholders as dividends. Dividends are taxed both as profit and as dividends by the government. This is the major downfall of a typical corporation. Because a corporation is treated like a separate individual by the government (which

The biggest decision by the Board of Directors is the hiring of a CEO, or Chief Executive Officer. The CEO manages the company's daily needs while the Board of Directors oversees the policy and long term issues.

The CEO and Board of Directors are subject to the Duty of Loyalty and a Duty of Care. Basically, this means that their actions are always in the best interest of the company, and that they've done everything reasonably possible to prevent a company failure.

If the CEO fails in this respect, it is the duty of the Board to remove him or her. If the Board fails to meet their obligations, the stockholders can recall a Board member by voting.

¹ Subchapters C, S, and T are named for the section of the Internal Revenue Code that determines their taxation rate.

is good in cases of liability), it is also taxed like an individual by the government. Profits made by a corporation are taxed like profits made by an individual. Because individuals are also taxed on gains through stock ownership from a corporation, the situation of double-taxation is inevitable.

This is the major advantage of a Subchapter S corporation is that the issue of double taxation is sidestepped. Subchapter S corporations are not taxed as regular corporations and are not subject to the double-tax situation. This might make you wonder why all corporations are not Subchapter S. The answer is that not all corporations meet the requirements to become a Subchapter S.

To become a Subchapter S, you have to meet several conditions, some of which include:

1. It can have no more than 100 members (it used to be as low as 75)
2. These stockholders must, in general, all be human beings that are US citizens (i.e. no businesses or organizations can be stockholders, or non-US residents, unlike in Subchapter C)
3. There can only be one kind of stock and one kind of stock owner.
4. The owners may not own more than 80% of another stock
5. All stockholders must agree to how profits will be distributed
6. No more than 80% of income may come from outside of the US.

If a corporation fails to meet any of these requirements at any point in a year, it automatically reverts to a Subchapter C, in which it is subject to double taxation. In general, if a corporation is eligible for Subchapter S status, it will seek it because of the money savings in taxes.

A Subchapter S corporation can have many benefits over a partnership. For example, it is possible to deduct living expenses from your taxes if you are required to live on a farm to do your job in a Subchapter S Farm. However, the main advantages are the reduced liability compared to a partnership and the elimination of double taxation compared to a Subchapter C.

A Coop is an ideal business model for consumers who need cheaper prices on the products they buy, or a higher price on the goods they sell. Coops are non-profit, meaning they can sell or buy products at cost.

A final kind of corporation is a **Subchapter T**. You may know this kind better as a cooperative. A cooperative by legal definition is a user owned, user controlled corporation with benefits distributed on the basis of usage. Cooperatives are by definition non-profits. Any money the coop has remaining after covering the cost of operation is returned to the members of that cooperative. For example, the members of a feed coop will receive their share of the profits from a particular year based on how much they contributed to and used that particular coop.

The Midwest, particularly Wisconsin, has one of the greatest rates of coop use. Coops can take many forms. There are obviously feed coops, but also electrical coops, credit unions, medical coops, and others. Members of a coop both use and own the business. They may buy from a coop, sell to a coop, work at it, or only invest in it. They may own it by purchasing shares or paying fees to become a member. These fees are then used to fund the business. They control the coop directly by voting on major decisions and indirectly by electing the board of

A Subchapter S Corporation is typically a small, family-owned corporation. It is sort of a blend between a partnership and a Subchapter C. It offers the financial security of a corporation without the double-taxation. However, only certain kinds of corporations can become Subchapter S.

directors. Members themselves can also run for positions on the board of directors. This means that a 50-cow dairy farmer can be a chief decision maker for a Fortune 500 company such as Land O Lakes or a small-time cranberry farmer can control Ocean Spray.

People join coops for many reasons, but the most common is economic. If you get a fair price for your product plus a dividend in addition, you are likely to make more money. However, there are also social reasons. Many organic farmers have started coops to better compete in difficult markets. South American coffee farmers have started coops to better bargain with large corporations such as Starbucks.

Coops have their origins in 1800s England. Around the time of Charles Dickens "A Christmas Carol", many average British citizens lived in abject poverty. Food was expensive and hard to come by. Many people died from starvation. In a small town called Rochdale, the modern coop was born. Realizing that they could sidestep high prices by becoming the sellers themselves, citizens in Rochdale created the model that all cooperatives follow today. The distinguishing characteristics are that...

1. Services and goods are sold at cost. Prices are cheaper because all coops are non-profit – there is no single owner to take profits, and so goods can be sold for nearly the price at which they were purchased. Any profits that are left after covering the cost of operation are returned to the members based on their use of the coop.
 - a. This encourages people to use the coop over other businesses
 - b. The more that use the coop, the better the prices they offer
2. Every member has one vote regardless of use. Coops are by their very nature the most democratic business form.
3. Investments have limited returns because the coop exists to offer lower prices, not to make money

The advantages of a cooperative are that owners have limited liability (because it is still a corporation), and that all profits and returns go back to the members. Large numbers in the membership offer better bargaining ability, more funds, and reduced costs due to economies of scale, and as non-profits, corporations are exempt from some government regulations and taxes that other corporations are subject to. Finally, coops are exempt from double taxation.

However, there are disadvantages as well. Investors will receive less money on their investment than in other corporations because of the member-oriented and reduced-cost nature of a cooperative. The larger the coop, the less control members have, and restrictive charter (start-up document) requirements hamper business competitiveness. In a coop, small groups can gain excessive power by "hijacking" the board of directors, and coops in general require a strong understanding of how the coop model is run. Most people tend to lack a true understanding of coop models, and this can lead to mismanagement, unfair demands for higher dividend payments, and lowered member participation.

Coops offer advantages such as better prices, more cooperation, financial security, and a strong democratic nature. However, coops are far from perfect. They require a high level of loyalty from their members, competent educated members, comprehension of the dividend model, and can be less competitive due to their slower, restricted nature.

Ultimately the type of business you would choose for your farm would vary. While most farms are sole proprietorships, every kind of business firm shown here has been used for a farm business. Depending on your needs, your size, your goals, and your competitiveness, any of the five kinds of business firms could be effectively used to operate your business.

Sole Proprietorships

Advantages

- You're the boss.
- It's easy to get started.
- You keep all profits.
- Income from business is taxed as personal income.
- You can discontinue your business at will.

Disadvantages

- You assume unlimited liability.
- The amount of investment capital you can raise is limited.
- You need to be a generalist. Retaining high-caliber employees is difficult.
- The life of the business is dependent on the owner's.

Partnership

Advantages

- Two heads are better than one.
- It's easy to get started.
- More investment capital is available.
- Partners pay only personal income tax.
- High-caliber employees can be made partners.

Disadvantages

- Partners have unlimited liability.
- Partners must share all profits.
- The partners may disagree.
- The life of the business is limited.

Corporation (Subchapter C, S, & T)

Advantages

- Stockholders have limited liability.
- Corporations can raise the most investment capital.
- Corporations have unlimited life.
- Ownership is easily transferable.
- Corporations utilize specialists.

Disadvantages

- Corporations are taxed twice (Sub. C only).
- Corporations must pay capital stock tax.
- Starting a corporation is expensive.
- Corporations are closely regulated by government agencies.

Sources: <http://www.powerhomebiz.com/vol3/legalstructure.htm>

Limited Liability Companies – The Newest and Final Kind of Business Firm

The limited liability company is an attempt to combine the best features of a partnership and a corporation, while avoiding the drawbacks. On one hand, sole proprietorships and partnerships have tax advantages, but they don't protect business owners from personal liability. Corporations can provide that liability protection, but their earnings can be taxed at both the corporate and individual level.

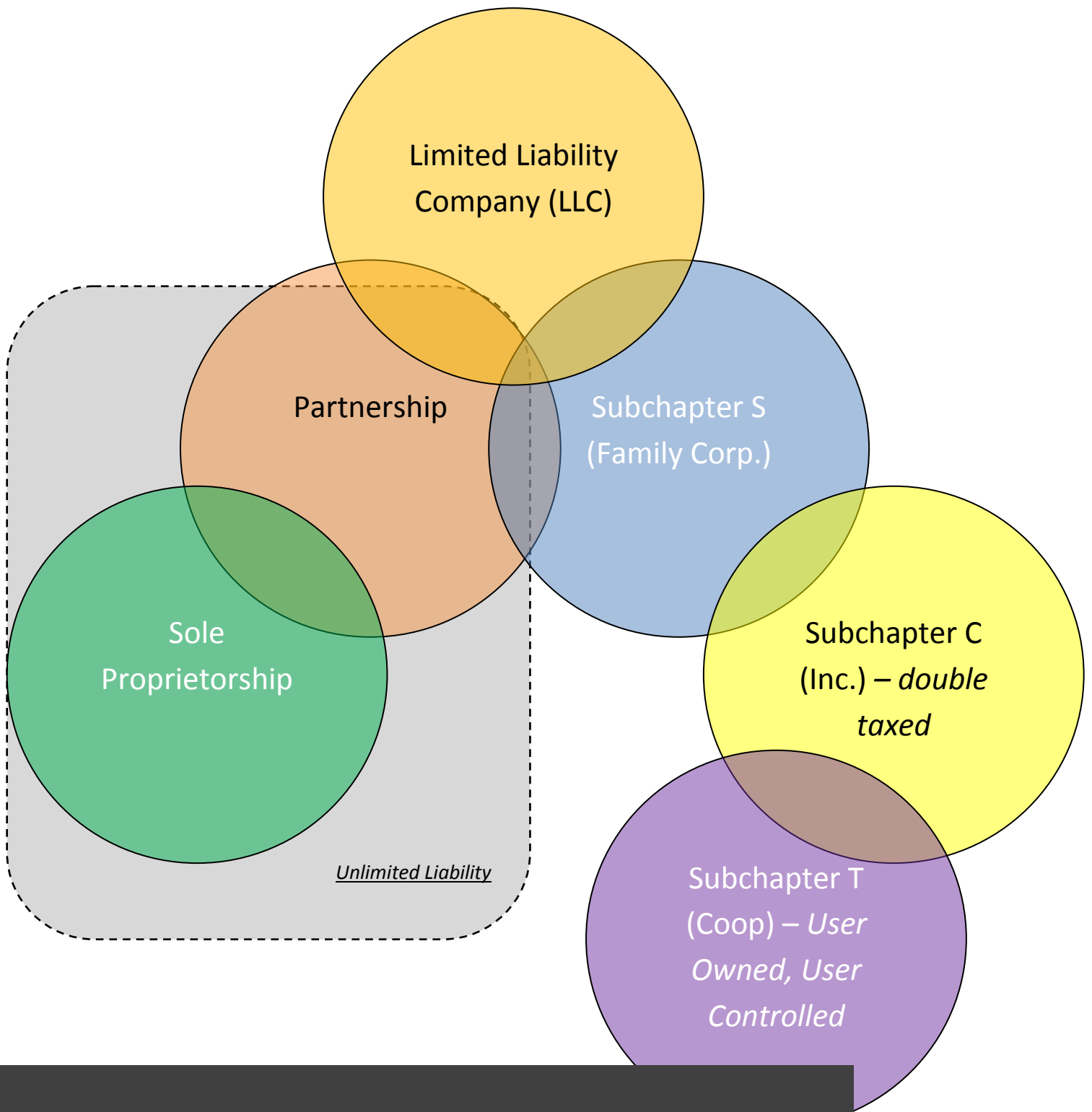
"The advantage of the corporation that we want to hold on to is the limited liability, hence its name," said Jim Libbin with NMSU's Cooperative Extension Service. "But like a partnership or subchapter S corporation, a limited liability company is taxed only at the individual level, avoiding the double taxation issue."

In addition, a limited liability company has some unique features of its own.

"You can have different types of owners than a subchapter S corporation can," he said. "For example, a non-resident alien can be a stockholder in an LLC. That can't happen in a subchapter S corporation."

Farmers and ranchers always should consult a financial adviser if they have questions about which organizational structure is best for their businesses.

Source: http://aces.nmsu.edu/news/1996/021296_taxliability.html



The Six Major Kinds of Business Firms are shown as they relate to each other. Sole Proprietorships and Partnerships are the most similar to each other in that both have unlimited liability, do not have register with the government, and require large inputs of time and resources. Subchapters T, C, and S are very similar in that they are all corporations, require startup documents and investments, and have limited liability. Subchapter S and Partnerships are similar in that neither is double taxed. A Subchapter S is a hybrid between a corporation and a partnership, offering limited liability without double taxation. An LLC is nearly the same, but with slightly fewer restrictions.

Assignment – Business Firms

Name: _____ Hour _____ Date: _____

Date Assignment is due: _____ Why late? _____
Day of Week Date If your project was late, describe why

- (24 pts) Instructions: complete the following table, describing how a farm would look under the six types of business firms.

Business Type	Startup - Easy or Difficult?	Government Oversight - Heavy or Light?	Doubled Taxed? Y or N	Limited or Unlimited Liability?	Life of Business Limited or Unlimited	Need to be Incorporated?	Has Stockholders?
Sole Proprietorship							
Partnership							
Subchapter C							
Subchapter S							
Subchapter T							
LLC							

- (1 pt) How might a sole proprietorship be better than a partnership? List 3 benefits of a starting a business alone compared to forming a partnership.

- (1 pt) How might a partnership be better than a sole proprietorship? List 3 benefits of a partnership compared to starting a business alone.

- (1 pt) What does it mean that sole proprietorships and partnerships have unlimited liability?

5. (1 pt) Why might someone choose to start a corporation over a sole proprietorship or partnership?

6. (2 pts) What does it mean that Subchapter C corporations are double taxed? How is it possible for the government to tax the same money twice?

7. (1 pt) How does a Subchapter S differ from a Subchapter C corporation?
 - (1 pt) Why aren't all corporations Subchapter S?

8. (1 pt) What is the legal definition of a cooperative?

9. (1 pt) How are cooperatives able to offer better prices for their goods and service than other kinds of businesses without losing money?

10. (2 pts) Why would a company need both a CEO and a Board of Directors? Why not just have one or the other? List two reasons why both are needed.

11. (2 pts) Who hires the CEO? Who hires the Board of Directors?

12. (2 pt) What is the Duty of Loyalty and the Duty of Care? Explain both below.