

# Legal Structures of a Business

The legal structure of your business can take three basic forms: Sole Proprietorship, Partnership or Corporation. Before you select the legal structure of your business, you should ask yourself the following questions:

1. **How much money do I need?**
2. **What will be the source of any needed funds?**
3. **What skills are needed that I cannot provide?**
4. **Are there other people available to round out the necessary skills in starting and continuing a business?**
5. **How much control do I have over the operation?**
6. **How will the business be taxed and how will applicable laws influence it?**
7. **To what extent will I be personally responsible for debts or claims against the business?**
8. **What happens to the business if I am not able to work for any length of time?**

There are many legal and tax considerations that will enter into this decision, so make sure you consult your attorney and your accountant.

## Sole Proprietorship

The sole proprietorship is the most common form of business organization. You own and operate the business and have sole responsibility and control. Essentially, you the owner, are the business. The profits of the business are considered as personal income and, therefore, are taxed at your personal tax rate.

### Advantages:

1. Ease of formation: fewer legal restrictions, usually least expensive
2. Flexibility: quick response to business needs
3. Profits: you have sole ownership of profits
4. Exclusive control and decision making: you are in charge
5. Tax deductions: losses are tax deductible

### Disadvantages:

1. Unlimited liability: you are responsible for the full amount of business debts, and this liability extends to your personal assets
2. Unstable business life: business could be terminated by your illness or death
3. Limited investment: investment is limited to the resources that you can raise

## Partnership

A partnership is the association of two or more people as co-owners of a business. It is a legal mechanism that allows for profits and losses to be divided among a group of investors. Partnerships are typically used by groups of professionals such as lawyers and accountants or for groups of real estate investors. When forming a partnership, you should have a partnership agreement developed that specifies the legal obligations of each partner. A partnership agreement will:

1. stipulate the initial amount of funding each partner will contribute to the business
2. determine how management decisions will be made and authority will be divided
3. establish methods for settling disputes among partners
4. set up a procedure for selling out: specify how each partner's interest will be valued; establish restrictions on selling partner's interest to a third party
5. specify what would happen to your business if one of your partners dies or becomes physically or mentally incapacitated
6. specify the rights of the partner's spouse. Standard form partnership agreements can be purchased for about \$5.00 at stationery stores.

### **Advantages:**

1. Ease of formation
2. More skills and capital available to boost performance and growth
3. Flexibility, decision making with relative freedom from government control and special taxation
4. Losses are tax deductible

### **Disadvantages:**

1. Unlimited liability
2. Personal liability of a solvent partner for the actions of unscrupulous partners
3. Unstable life of business: partnership is dissolved if a partner dies or withdraws, unless specifically prescribed for in the written agreement
4. Buying out a partner may be difficult unless specifically prescribed in the written agreement
5. Potential for disagreements between partners could lead to costly dissolution

## "Limited" Partnership

Limited partners are liable only to the extent of their investment and do not share in the management of the business.

### Advantages:

1. A person can invest capital in a partnership business and reap a share of the profits without becoming liable for all debts of the partnership or risking more than the amount of capital contributed

### Disadvantages:

1. Must have at least one partner who is liable for all debts of the partnership, and other (limited) partners whose liability is limited to their investment
2. No voice in the management of the partnership
3. There are other legal and tax considerations involved, and legal advice is necessary in choosing this form of organization

## Corporation

The most complex form of business organization is the corporation. A corporation is made up of three groups of people: shareholders, directors and officers. The corporation can borrow money, own assets, and perform business functions without directly involving you or the other corporate owners.

### Advantages:

1. Limitation of the stockholders' liability to a fixed amount, usually the amount invested (Be aware that virtually all lenders will require you to sign a personal guarantee for any funds your incorporated business wishes to borrow. This essentially eliminates what used to be one of the main advantages of incorporating your company)
2. Business looks more credible than a sole proprietorship to potential suppliers, employees, and bankers
3. Ownership is readily transferable
4. Separate legal existence
5. Relative ease of securing capital in large amounts and from many investors

### Disadvantages:

1. Activity is limited by the corporation's charter and various laws
2. Extensive government regulation; burdensome federal, provincial, and local reports

# Legal Structures of a Business

3. Considerable expense in formation of corporation
4. Greater administrative expenses on an annual basis

## For More Information

**Internet:** <http://www.smallbusinessbc.ca>

**Books:** Business for Beginners: A Simple Step-by-Step Guide to Start Your  
New Business 2<sup>nd</sup> ed. Frances McGuckin