2.1 SOLE PROPRIETORSHIPS

ADVANTAGES
✓ Easy to start up; low or no start-up costs
✓ No formation and reporting requirements
DISADVANTAGES
☒ No limited liability for the individual; individual is responsible for the debts and obligations of the business
☒ Limited to a single owner
☒ Not suitable for raising outside capital
CASE STUDY (FICTIONAL)
Soledad Prosepina owns and operates a sole proprietorship that offers sustainable design consulting services. She specializes in advising on environmentally-sensitive structures and sustainable solutions for the built environment. She sees overall energy and environmental performance as a core goal and attempts to integrate sustainable design principles and strategies into all aspects of a project. Her mission is to help clients identify new sources of business value while benefiting the environment and the communities in which these developments are located.

a) Overview

Sole proprietorships are the oldest, simplest and most common form of business enterprise. More than 24 million sole proprietorships were operating in the United States in 2013, outnumbering corporations and partnerships combined by a factor of two.[1]

Many types of businesses may be run as sole proprietorships. The predominant quality that defines a sole proprietorship is that it does not have any legal status or structure separate from its owner. The proprietor and the business are inseparable and indistinguishable in the eyes of the law, which impacts nearly all aspects of how the business is formed, structured, operated, regulated and taxed.

A sole proprietorship may only have one owner, who must be an individual. The introduction of additional owners will automatically and by definition change the business into a partnership. Thus, a sole proprietorship is not a viable business form for individuals who wish to have partners or business associates to help them manage or run the enterprise. Also, this means that sole proprietors do not have the option to issue ownership interests in the business to investors in exchange for funding without adopting a different form of business enterprise.

1. https://www.irs.gov/pub/irs-soi/13otidb1.xls.

Sole proprietorships have certain structural benefits such as:

Simplicity – The sole proprietorship is the most basic and inexpensive type of business entity to form and operate, with minimum startup costs and few formal requirements.

Flexibility and Control – The owner has complete control and authority to manage the business and its finances.

Pass-Through Taxation – For tax purposes, a sole proprietorship is not treated as an entity separate from its owner. Thus, the owner reports the income, gains, deductions, losses and credits of the proprietorship directly on his or her personal income tax returns.

Sole proprietorships also face significant drawbacks, including:

Unlimited Personal Liability – Owners of sole proprietorships are personally liable for the obligations of the business.

Difficulty Raising Capital – Sole proprietors are greatly limited in their access to financing.

Another attribute of sole proprietorships is that they lack continuity. The enterprise is so closely bound to and dependent upon its owner that its existence is more precarious than other business forms. When the sole proprietor dies, the enterprise will terminate. Even if the proprietorship assets are assumed by the heirs of a deceased owner who continue to operate the business under the same name, the business has legally ended, and a new enterprise has been formed by the new owner or owners. Similarly, if the sole proprietor sells the assets of the business, the sole proprietorship ceases, and a new business is formed by the buyer. By contrast, when a shareholder of a corporation dies, or transfers or sells his or her stock, the business may continue to exist and operate without disturbance. The lack of continuity of a sole proprietorship is a disadvantage in that the enterprise might not communicate a sense of stability or assurance to third parties, who may be hesitant to become involved with a company that could end abruptly. The potential risk of sudden termination could deter lenders from extending credit to the business and prevent the enterprise from attracting qualified employees.

b) Organizational Structure

There is no formal structure required for a sole proprietorship, since the owner is the sole decision maker for the business, with full power to control all aspects of how the business is operated and how any money is handled. The simplicity of the business form allows the owner to spend more time building and running the enterprise and less time tied up with paperwork or other formalities. In contrast, corporations, LLCs and partnerships must abide by or set up various structural guidelines for how the business is managed, how decisions are made and which individuals are entitled to engage in such management and decision making. The sole owner has complete discretion in a sole proprietorship; thus, business planning and organizational arrangements such as operating agreements or bylaws are not required.

c) Establishment and Documentation

A sole proprietorship is simple and inexpensive to start compared to other business forms. Unlike a corporation or LLC, no formation documents are required to be filed with the state when forming a sole proprietorship. This can save a business from filing fees, as well as from the expense associated with preparing such formation documents. To bring a sole proprietorship into existence, the owner simply needs to begin conducting business. In fact, many individuals run sole proprietorships without even realizing it; independent contractors, consultants and freelancers are all sole proprietors simply by virtue of doing their jobs.

The sole proprietor should obtain any and all registrations, licenses and permits required from the federal, state and local governments to run the business and make it legitimate. For example, a business enterprise may require a state or local sales tax permit if it intends to sell retail merchandise, a health permit if it is handling food or a liquor license if it plans to dispense alcohol. Sole proprietors are also often required to register with local tax authorities and pay at least a minimum tax in exchange for a business license or tax registration certificate. Banks may require a sole proprietor to show such a business license or sales tax license when opening a new business bank account.

Additionally, a sole proprietorship may be required to obtain a federal employer identification number, or EIN, from the Internal Revenue Service if it has employees, a qualified retirement plan, or files returns for excise, alcohol, tobacco or firearms taxes.[2] A sole proprietor may elect to apply for an EIN even if one is not required for his or her business. Otherwise, the sole proprietor may simply use his or her social security number for tax reporting.

Fictitious Business Names

A sole proprietor may do business under his or her own legal name. For instance, if John Smith opens a mechanic shop, he may simply operate as "John Smith Auto Repair." Alternatively, John may select a different business name like "Big City Auto Repairs." Such a business name is referred to as a trade name, fictitious name or "DBA," which stands for "doing business as."

A sole proprietor will first need to ensure that the fictitious business name he or she has selected is available, meaning that the name isn't the same as or overly similar to a name already being used by another entity in a way that could prevent the sole proprietorship from adopting such name. In the example above, if Mike Jones owns "Big City Auto Repair" across town from where John opens his new business, Mike may accuse John of infringing on his trademark rights in an attempt to force John to change the name of his shop or even pay monetary damages. Whether Mike is successful will depend on how likely it is that one business will be confused for the other: the resemblance of the names, similarity between the types of business operated and relative locations are all factors to be considered in such a determination. A sole proprietor can do diligence on name availability by conducting a screening search using an online search engine, reviewing state or local fictitious name databases and searching federal and state registered trademark databases.

2. The EIN is obtained by filing a form SS-4, which may be completed by mail, online, by fax or over the phone.See, e.g., https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employer-ID-Numbers-EINs.

After a sole proprietor has verified that the selected fictitious business name is available, he or she must comply with any state and local requirements to register such name. Such requirements may vary from state to state.[3] For example, New York requires the filing of an Assumed Name Certificate with the county clerk's office where the business is located, and all businesses operating under a fictitious name in Florida must register with the state Division of Corporations.[4]

d) Liabilities

One of the primary disadvantages of a sole proprietorship is that a sole proprietor is personally liable for the obligations incurred by the business. Unlike a limited liability company or corporation, where the business is a separate entity that shields its owners from liability, the sole proprietorship and the sole proprietor are one and the same, and the liabilities of the business are not separate from its owner. This means that if the sole proprietorship cannot meet all of its obligations, the assets of the owner, including his or her bank account, car or even home, can be accessed to satisfy such obligations.

Sole proprietors are subject to all unmet obligations of the business, including unpaid debts to contract creditors (such as suppliers or lenders who the business has contractually agreed to pay back) as well as judgment creditors (such as tort plaintiffs who bring successful legal proceedings against the business). Moreover, a sole proprietorship, and thus the sole proprietor, is liable for the obligations created by its employees in the course of employment.

The exposure to personal liability should be considered carefully when deciding on a form of business entity. In particular, if the contemplated business enterprise involves a moderate or high degree of risk or is in an industry with a reputation for litigation, a sole proprietorship may not offer adequate protection against the potential liabilities associated with such business. In such cases, the business owner may want to consider forming a corporation or limited liability company to protect his or her personal assets. Additionally, a sole proprietor should obtain adequate insurance coverage to provide protection against liabilities.

e) Governance and Regulatory Obligations

The sole proprietorship does not impose any internal governance obligations on its owner. The sole proprietor has complete ownership and thus complete control over how the business is run without the approval of any committee or requirement for any vote. No formal records are required by law, though a sole proprietor should still take it upon him or herself to set up proper business records and financial statements. While the informality, and thus simplicity, of sole proprietorships may be an advantage that makes them attractive to their owners, the lack of structure and financial controls may lead to the failure of a small business. Moreover, inadequate record-keeping could pose a challenge for calculating income taxes and could deter potential customers, suppliers and lenders alike from engaging with the business.

3. See http://www.sba.gov/content/register-your-fictitious-or-doing-business-dba-name for a guide to registration requirements by state.
4. https://efile.sunbiz.org/ficregintro.html.

In addition, sole proprietorships must comply with all federal, state and local tax filings and must follow all procedures to keep any regulatory filings (such as business licenses and permits) up-to-date.

f) Tax Treatment

A sole proprietorship is not treated as an entity separate from its owner for tax purposes; in tax parlance, the sole proprietorship is "disregarded" for tax purposes. Thus, the owner reports the income, gains, deductions, losses and credits of the proprietorship directly on his or her personal income tax returns.

A sole proprietorship does not pay separate income taxes, and, accordingly, only one level of tax applies to the income and gains of the business. Conversely, deductions, losses and credits of the sole proprietorship often are usable by the owner to offset income generated by the owner elsewhere, subject to certain limitations. Moreover, because the sole proprietorship is disregarded, cash or other property generally can be moved in and out of the sole proprietorship (for example, in and out of its bank accounts) with no tax consequences.

Under some circumstances, use of a sole proprietorship also simplifies, and thereby reduces the costs of, tax reporting because the income, gains, deductions, losses and credits are not reported separately from the tax returns of the owner. At the same time, the interaction of the tax items of a sole proprietorship with the other tax items of the owner can become complicated, particularly if the proprietorship uses special methods of accounting for the business. Furthermore, an owner cannot be an employee of his or her sole proprietorship for income tax purposes. Thus, owners generally will have to pay periodic estimated taxes throughout the year (rather than having taxes withheld from paychecks or other cash received by the owner) and will have to pay self-employment taxes on income (in effect, both the employer and employee portions of Social Security and Medicare taxes, subject to a deduction for half of such taxes).

It is important to note that sole proprietorships may not be eligible to take advantage of business incentives enacted under tax laws applicable to certain loss deductions, benefit plans and similar matters.

Keep in mind that, like all businesses, the owner of a sole proprietorship is also responsible for any other applicable taxes in addition to federal income taxes, such as excise taxes, employment taxes and any state or local taxes, including sales taxes and property taxes.[5]

g) Financing

Another drawback of running a sole proprietorship arises in the context of raising capital. Most sole proprietorships start with limited funds pulled together from the owner's personal wealth, loans from family and friends or consumer loans from banking institutions. This initial capital may be enough to begin running a business and generating a stream of income, and a sole proprietor may choose to reinvest any or all of such income back into the enterprise. As a business grows and expands, however, larger amounts of capital may be needed to buy more equipment, hire new employees or rent larger operating space. Though the need for funding for a sole proprietorship may increase over time, the sources of available funding remain limited due to its organizational structure.

5. See https://www.sba.gov/business-guide/manage-your-business/pay-taxes for state and local tax obligation resources.

Partnerships, limited liability companies and corporations may issue ownership interests in the form of partnership interests, membership interests or capital stock in exchange for funding. In contrast, a sole proprietorship can only have one owner; thus, a sole proprietor is inherently precluded from issuing any type of equity interest to raise capital. When a second person becomes an owner of the business, the organization is by definition transformed into a partnership (described in Section 2.2) and has the advantages and disadvantages associated with that type of enterprise. At this point, sole proprietors often will choose to form a limited liability company or corporation, as opposed to defaulting to a partnership structure.

h) Resources

For additional information, visit:

http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Sole-Proprietorships.

http://www.sba.gov/content/sole-proprietorship-0.

https://www.ftb.ca.gov/businesses/structures/sole-proprietorship.shtml.