FORMS OF BUSINESS ORGANIZATIONS

Learning Objective

- To differentiate the forms of business organizations

Key Understanding

- Understanding of the forms of business organizations in order to identify the advantages and disadvantages of each form.

Key Question

- What are the forms of business organizations?

Forms of Business Organizations

- There are four forms of business organizations available to aspiring businessmen — *sole proprietorship*, *partnership*, *corporation*, and *cooperative*.
- Each form has its own advantages and disadvantages.
- Aspiring businessmen take these into consideration before deciding what form their businesses will take. However, some types of businesses are not permitted to use some form of business organization.
- For example, businesses formed by individuals for the practice of their profession are not allowed to be corporations.

Sole Proprietorship

- Considered the simplest form of under which a business can operate, sole proprietorships are businesses formed by a single individual, but unlike partnerships and corporations, businesses operating under such setup do not have separate legal existence from the owner. The law does not recognize a sole proprietorship as a separate juridical entity distinct from the owner. As such, the owner usually transacts with other parties under his or her own name.
- Even though sole proprietorships do not have separate legal existence, owners can opt to operate the business under their own names or use fictitious names such as Aling Nene Sari-Sari Store. Fictitious names are merely trade names that aim to instill recall to customers. Thus, fictitious names do not, in any way, result in a separate juridical personality for the business.

Advantages of a Sole Proprietorship

1. Ease of formation

- ✓ Sole proprietorships are much easier to establish than other forms of business organizations because it does not have to go through a rigid registration process before it can operate.
- ✓ Here in the Philippines, sole proprietorships can register in the local municipal hall. Business permits and other licenses can also be acquired from such places. The whole process is easy and inexpensive, and it normally spans for only a short amount of time.
- ✓ Sole proprietorships can be formulated even with small amounts of capital. *Carinderias* and *sari-sari* stores are prevalent businesses operating as sole proprietorships which do not require huge amounts of investments.

Advantages of a Sole Proprietorship

2. The owner has full control of the business

- ✓ Being a sole proprietorship, the owner can single-handedly decide on matters pertaining to the business. Unlike partnerships and corporations that regularly hold meetings to make company decisions, sole proprietors can easily make decisions to solve problems faced by the business. The importance of fast decision-making is emphasized when problems warrant immediate action.
- ✓ Having only a single owner, a sole proprietorship does not experience internal conflict regarding business decisions. Internal conflict can be harmful business. In the worst case scenario, it can even be the cause of the downfall of the business.

Advantages of a Sole Proprietorship

3. Owners can mix personal and business assets

- ✓ Owners may freely mix their personal assets with business assets since sole proprietorships are not separate juridical entities distinct from the owners. Partnerships and corporations do not have this advantage.
- ✓ If a business is experiencing financial difficulties, a sole proprietor may use personal assets to help the business recover. This is not the case for partnerships and corporations since additional investments of owners in such corporations alter their profit-sharing structures.

Advantages of a Sole Proprietorship

4. Owners have all the profits for themselves

- ✓ All the profits generated by a business operating as a sole proprietorship belong to the owner. The determination of profit-sharing schemes is often a problem encountered by other forms of business organization.

5. Simple taxation

- ✓ The profits of a sole proprietorship are considered the income of the owner. Thus, the owner needs only to declare the income of the business in his or her tax return and it will be taxed accordingly.

Disadvantages of a Sole Proprietorship

1. Unlimited liability

- ✓ An owner of a sole proprietorship is personally liable for all the debts incurred by the business since a sole proprietorship has no separate legal existence distinct from the owner. The owner and the sole proprietorship are treated as one.
- ✓ *Unlimited liability* means that creditors, customers, the government, and other outside parties can go after the personal assets of the owner even after extinguishing all the assets of the business in the satisfaction of their claims. This is a huge risk that sole proprietors face. The law does not provide protection to the personal assets of the owner unlike in corporations.

Disadvantages of a Sole Proprietorship

2. Difficulty of raising additional capital

- ✓ As mentioned, sole proprietorships are characterized by having only one owner. The initial investment of the owner is the capital of the business. When all of the initial investment is used up, the owner is the only person that can provide additional capital. A sole proprietorship cannot sell interest (i.e., ownership rights) in the business. Doing so would defeat the purpose of being a sole proprietorship.
- ✓ In case a sole proprietor does not have enough resources to use as capital, the only remedy available to the business is to look for creditors willing to lend additional funds.

Disadvantages of a Sole Proprietorship

3. Owner's bias

- ✓ Only the sole proprietor has the authority to make decisions for the business. When deciding how the company will move forward, the owner always has the final word. This can possibly be detrimental to the business especially when the owner's bias prevails and he or she does not make rational decisions.
- ✓ Other forms of business organizations that have multiple owners do not usually have this problem. Biases do not usually prevail in the other forms of business organizations since there are many owners who decide.
- ✓ Having more decision makers is equivalent to having more minds to think of ideas on how to improve the business or how to solve problems encountered by the business. The workload of a sole proprietor is also much heavier than the owners of other forms of business organizations.

Partnership

- According to the Partnership Code of the Philippines, a *partnership* is a contract whereby two or more persons bind themselves to contribute money, property, or industry to a common fund, with the intention of dividing the profits among themselves. Two or more persons may also form a partnership for the exercise of a profession.

Partnership

From this definition of partnership given by the law, we can take note of the following:

1. Two or more persons are needed to form a partnership.
2. Money is not the only resource that a person can contribute in a partnership. *Property* refers to other assets owned by a person. Examples are land, building, vehicles, etc. *Industry* refers to the skills and expertise of a person.
3. A partnership must be established for the purpose of obtaining profit. If an organization is created for purposes other than the generation of profit (e.g., charitable institutions, public hospitals), it cannot take the form of a partnership.
4. Partnerships are the common form of business organizations used by companies who generate profits by the practice of a profession (e.g., law firms, auditing firms).

General Features of a Partnership

1. Separate legal existence

- ✓ A partnership can also be defined as an artificial being created by operation of law. This results in partnerships having juridical personalities separate and distinct from their owners (called partners). Being an artificial person, a partnership can perform the acts that the partners can do except those acts that are purely personal in nature. Some examples of these acts are voting in elections and holding positions in public office.

2. Mutual agency

- ✓ Partners, being co-owners of the business, can perform acts for the partnership even without asking permission from other partners. *Mutual agency* means that the acts of a partner are binding on a partnership even though he or she has no authority to do so as long as the act concerns the normal business operations of the partnership.

General Features of a Partnership

3. Unlimited liability

- ✓ Even though a partnership has separate legal existence, partners are still liable for debts and obligations that cannot be paid by partnership assets. Like in a sole proprietorship, creditors and other parties can go after the personal assets of the partners when partnership assets are not enough to satisfy their claims. Creditors can claim the deficiency from any of the partners or from all the partners.

4. Limited life

- ✓ The life of a partnership can be easily ended through partnership *dissolution* or *liquidation*. *Partnership dissolution* occurs when one of the partners withdraws from the partnership or if a new partner is admitted. *Dissolution* occurs when there is a change in the relationship among the partners. Dissolution of a partnership does not necessarily mean that the partnership will cease to exist. Withdrawal and admission of partners are normal occurrences in a partnership, and they only lead to the formation of a new partnership. *Partnership liquidation*, on the other hand, ends the operations of the partnership

General Features of a Partnership

5. Co-ownership of partnership property

- ✓ In the formation of a partnership, partners contribute money, property, and industry into a common fund. Once a partner has contributed his/her money and/or property, it does not belong to him/her anymore. The contributed money and property belong to the partnership and the partners only have a proportionate share of partnership assets.

6. Partnership agreement

- ✓ The definition provided by the law states that a partnership is a contract. *Contracts* are perfected through oral or written agreement. Thus, a partnership can be formed orally or in written form. However, to protect the interests of all partners, it is ideal to form a partnership in a written contract. This written contract is called the *articles of partnership,* and it contains the following:
  1. Name of the partnership
  2. Location of the principal office of the partnership
  3. The names, citizenship, and residence of the partners
  4. Term for which the partnership is to exist
  5. The purposes for which the partnership is formed
  6. Original capital contributions of the partners
  7. Profit and loss sharing agreement among the partners

Advantages and Disadvantages of a General Partnership

Advantages

- ✓ Easier to create than a corporation
- ✓ Better ability to acquire additional capital than sole proprietorships
- ✓ Larger pool of human capital than sole proprietorships

Disadvantages

- ✓ Unlimited liability
- ✓ Mutual agency
- ✓ Limited life

Other Forms of a Partnership

Limited Partnership — In a limited partnership, at least one partner has unlimited liability and at least one partner has limited liability. Partners having unlimited liability are called *general partners* while partners having limited liability are called *limited partners*. Limited partners are exposed to a lower level of risk.

Limited Liability Partnership — It is a type of partnership that aims to protect innocent partners from the malpractice and wrongdoings of other partners. This kind of partnership possesses multiple insurance claims to protect the partners from such wrongful acts of other partners. The limited liability partnership is mostly used by individuals forming a partnership for the practice of a profession (e.g., lawyers, accountants, medical professionals, auditors).

Limited Liability Company — It is another form of organization having partnership characteristics. Limited liability companies have features of both a corporation and a partnership. The owners are called *members* and they enjoy limited liability. Unlike the limited partners in a limited partnership, members of a limited liability company can participate in management without losing the limited liability protection. (Weygandt et al. 2008)

Other Forms of a Partnership

Form of Partnership	Advantages	Disadvantages
General Partnership	Simple and inexpensive to create and operate	Owners (partners) personally liable for business debts
Limited Liability Partnership	Limited partners have limited personal liability for business debts as long as they do not participate in management. General partners can raise cash without involving outside investors in management of business.	General partners personally liable for business debts More expensive to create than regular partnership Suitable mainly for companies that invest in real estate
Limited Partnership	Mostly of interest to partners in old-line professions such as law, medicine, and accounting. Owners (partners) are not personally liable for the malpractice of other partners.	Unlike a limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders, and landlords. Often limited to a short list of professions.
Limited Liability Company	Owners have limited personal liability for business debts even if they participate in management.	More expensive to create than regular partnership

Corporation

Our law defines a corporation as "an artificial being created by operation of law, having the right of succession and the powers, attributes, and properties expressly authorized by law or incident to its existence." This definition emphasizes four things about a corporation. These are:

1. A corporation is an artificial being. It means that it is an entity separate and distinct from its owners.
2. A corporation is created by operation of law. Individuals cannot form a corporation by themselves. The law must play a role in the formation of a corporation.
3. A corporation has the right of succession. Ownership rights can be passed to other persons through sale, donation, or any other mode of transfer.
4. The law is the source of the powers and attributes of a corporation. Being the source, the law can likewise restrict the authority of corporations in performing acts.

General Features of a Corporation

1. **Separate legal existence.** Just like a partnership, a corporation is treated by law as an artificial being separate and distinct from its owners. A corporation can enter into contracts and transactions under its name. It can also perform acts that can be done by natural persons except those that are purely personal in nature such as voting and holding positions in public office.
2. **Limited liability.** This characteristic is an advantage a corporation has over a partnership. The personal assets of the stockholders of a corporation are protected from the claims of creditors and other outside parties. Thus, the maximum loss that a stockholder can bear equals his or her investment. This characteristic is a major consideration of aspiring businessmen who do not want to be exposed to too much risk. Even if the corporation is bankrupt or has unpaid claims due to accidents and lawsuits, the stockholders cannot be obligated to pay any deficiency.

General Features of a Corporation

3. **Transferable ownership rights-** Ownership rights in a corporation are represented by stocks. A *stock is an intangible* (i.e., no physical form) asset evidencing a proportionate share in the properties of a corporation. A stock is represented by a stock certificate. If an individual has stocks of a corporation, he or she is an owner of the company. Stocks can be transferred to other persons through sale, donation, or other modes of transfer.
4. **Virtually unlimited life-** A corporation shall exist for a period not existing 50 years from the date of its formation. The term of a corporation may, however, be extended for periods not existing 50 years. This gives corporations virtually unlimited life. As long as the stockholders want to continue business operations, they are allowed to extend the life of the corporation. There is no limit to the number of extensions a corporation can avail of. A corporation is also not affected by the withdrawal, death, and admission of stockholders.

General Features of a Corporation

5. **Corporation management.** The management structure of a corporation is more complex than that of the other forms of business organizations. Stockholders are the owners of a corporation. However, unlike in sole proprietorships and partnerships where the owners or partners manage the business, stockholders may elect a board of directors to manage the corporation. The board of directors represents the interest of the stockholders and they are responsible for creating operating policies for the company. Stockholders can also be a member of the board of directors. The board delegates individuals to certain positions. The board selects the president or chief executive officer and the other vice-presidents.

General Features of a Corporation

6. **Government Regulations.** Corporations are subject to stricter government regulation than sole proprietorships and partnerships. Being major contributors to the income of the whole economy, the operations of corporations are closely monitored by the government. Large corporations provide employment opportunities to the public and stimulate the growth of the company. The bankruptcy of a large corporation can cause the whole economy to also spiral downwards. Government regulations are designed not only for the protection of public interest, but also for the stockholders' as well.
7. **Double Taxation.** The income of a corporation is taxed on the corporate level and the individual level. The income of a sole proprietorship or a partnership is part of the individual income of the owners. It is taxed once the owners file their respective tax returns. In a corporation, the income is already taxed before being distributed to the stockholders. Once a stockholder receives his or her share of the income, it is included in his or her tax return and will be taxed for the second time.

General Features of a Corporation

8. **Dividends.** The corporation is not required to distribute to stockholders the income it generated from operations. The stockholders of a corporation will only be entitled to receive a share of the income once the board of directors approves the distribution. The income distributed to stockholders is called *dividends.*

Dividends may be in the form of cash, stock, or property. Cash dividends are distribution of income in the form of cash. It is normally stated as a nominal amount of per share of stock.

Even though the approval of the board of directors is necessary before income can be distributed, dividends are given to the stockholders on a regular basis to keep them happy. If stockholders do not regularly receive dividends, they tend to become dissatisfied and sell their stocks.

Advantages and Disadvantages of a Corporation

Advantages

- ✓ Ability to acquire additional capital
- ✓ Transferable ownership rights
- ✓ Limited liability of stockholders
- ✓ Virtually unlimited life
- ✓ Large pool of human capital

Disadvantages

- ✓ Heavily regulated by the government
- ✓ Double taxation
- ✓ Not easy to form
- ✓ More expensive to form than sole proprietorships and partnerships

Cooperatives

- According to the Cooperative Code of the Philippines, "a *cooperative is a duly* registered association of persons, with a common bond of interest, who have voluntarily joined together to achieve a lawful common social or economic end, making equitable contributions to the capital required and accepting a fair share of the risks and benefits of the undertaking in accordance with universally accepted cooperative principles."

- From this, we can see that a cooperative is an association of individuals who share a common goal. Membership in a cooperative shall be voluntary and available to all individuals regardless of their social, political, racial or religious backgrounds and beliefs

Cooperatives

According to the same Code, the primary objective of a cooperative is to provide goods and services to its members and enable them to attain increased income and savings. A cooperative may be formed by at least 15 persons for any of the following purposes:

1. To encourage thrift and savings mobilization among the members
2. To generate funds and extend credit to the members for productive and provident purposes
3. To encourage among members systematic production and marketing
4. To provide goods and services and other requirements to the members
5. To develop expertise and skills among its members
6. To acquire lands and provide housing benefits for the members
7. To insure against losses of the members
8. To promote and advance the economic, social, and educational status of the members.

Cooperatives

Other characteristics of a cooperative include the following:

1. It can sue and be sued under its own name.
2. It has the right of succession.
3. Members of a cooperative are subject to limited liability.
4. It shall exist for a period not exceeding 50 years from the date of formation. The cooperative term may be extended for periods not exceeding 50 years.
5. A cooperative has its set of board of directors.
6. Income of a cooperative (called net surplus) belongs to its members.