Lesson 6: Legal Forms of Business

Overview: Entrepreneurs have a vision about what a business might be like. When thinking about the positives, the vision is probably one of good fortune and success. But, as you can imagine, unfavorable things may happen. Revenues may not be enough to pay all the bills, accidents can happen, and many other contingencies may mean the entrepreneur has financial responsibilities that must be met. The legal form under which the firm operates can have an impact on the financial position of the entrepreneur. Here we will want to explore issues relating to the legal forms of business called sole proprietorship, partnership and corporation.

Economic Concepts:
- Legal forms of business
- Limited liability
- Double Taxation

Objectives: The students will be able to:
1) Describe the difference between limited and unlimited liability.
2) Describe the way in which corporate stockholders are taxed twice.

Nebraska Standards:
SS/H—8.3.5, 8.3.6, 12.4.17, 12.4.26, 12.4.27
R/W—005.01D, 005.02E, 005.03A, 005.03B, 005.04A, 006.01B, 006.02E, 006.03A, 006.03B, 006.04A

Materials:
1) Overhead transparency of Activity Sheet 6-1

Time required: 1 or 2 class periods
Procedures:
1) Put transparency of Activity Sheet 6-1 on the overhead and go over the terms with class.

2) Have the students go into the community and ask several business owners what legal form of business they have. Ask doctors and lawyers in town, if there are any. Also go to restaurants and grocery/convenience stores.

3) Divide the class into groups of three or four students. Within their groups they should discuss and record how liability and taxation issues might have influenced the community businesses, researched in step 2, to choose their legal form of business.

4) When the groups have finished discussing and recording their findings, have one person form each group report their findings to the rest of the class. Each group should report all of their findings even if an earlier group has analyzed their business. (This is a real possibility for students located in small towns with a limited number of businesses)

5) Assign the students to write a one or two page paper that describes a business they would like to have. Have them include a discussion of how liability and taxation issues will influence what legal form their business will have. If your school incorporates six-trait writing, let them know what traits to concentrate on for this paper.

Assessment:
1) A business with only one owner and no stock issued is a ...
   A. partnership
   B. corporation
   C. S corp
   D. sole proprietorship*

2) An advantage to organizing a business as a sole proprietorship is ...
   A. limited liability.
   B. having someone to share the expenses of start up.
   C. single taxation of profits.*
   D. unlimited liability.
3) The earnings of a corporation are subject to double taxation when the Board of Directors ...

A. pay dividends to stockholders.*
B. retain the after tax income for operations.
C. subtract expenses from revenue.
D. set prices.

**Extension Activity:**

Invite a local lawyer or accountant to visit your class and discuss the steps that must be taken to incorporate a business. They should also share their views on both the advantages and disadvantages of a corporation, partnership, and sole proprietorship as a form of business operations.

For more information on starting a business in Nebraska, visit the Nebraska Business Development Center at [http://nbdc.unomaha.edu](http://nbdc.unomaha.edu). Click on the Publications button; click on the web version of the publication “Keys for Successful Business Start-Up. Scroll down the left hand side and click on “Steps to Start a Business in Nebraska.” This page also includes many additional links.
Activity 6-1

Types of Businesses

A **corporation** is a form of business where *shares* of ownership have been issued in the form of stock. Owners of the stock have limited liability, but are open to double taxation. There can be a few, or millions of owners of the company.

A **sole proprietorship** is a form of business where there is one owner and no stock has been issued. The owner of the company faces unlimited liability, but only single taxation.

A **partnership** is just like a sole proprietorship, except there is more than one owner.

**Liability**

Liability means responsibility. Entrepreneurs as owners of firms are responsible for the bills of the firm. How much responsibility depends on the legal form the business takes.

Limited liability means the responsibility of the owner(s) is limited to the dollar amount invested in the business. If financial obligations are larger than this, then the owner is not obligated to cover the obligation. For instance, personal assets could not be taken to meet the obligation.

Unlimited liability means the responsibility of the owner(s) is unlimited. If financial obligations are more than the owner has invested in the company, then the owner could have to give up personal assets, like a car, in order to satisfy the financial obligation.
Activity 6-1 (cont.)

Taxation

Businesses sell a product (or many different types of products) and collect revenue. The government requires business to pay taxes on the revenue that is left over after expenses are paid. So, revenue net of expenses is the basis for taxation.

After tax income is revenue minus expenses minus taxes paid. This is the end of the story for sole proprietors and partnerships. In the corporate form of business, the after tax income may be given to the owners in the form of a dividend. If not, the after tax income is retained by the corporation and used for operations.

Dividends are really revenues from sales minus expenses and taxes that are given to the corporate stockholders. Once the stockholder receives the net revenue the government taxes the net revenues again at the stockholder level as part of their income. Thus the net revenues are taxed again – double taxation!