

Types of Business Organizations: Advantages & Disadvantages

Lesson Transcript

Cite this lesson 

In this lesson, you will learn about the three main types of business organizations: sole proprietorship, partnership, and corporation. We'll also discuss the advantages and disadvantages of each.

Types of Business Organizations

At the age of 18, Alvin invented a widget that changed the way people drive cars. Many large automobile manufacturers were interested in purchasing the widget and offered him large, seven-figure contracts. Alvin, who was an expert in automobiles, knew little about negotiating contracts, running a business and marketing.

He decided to go to his attorney friend and ask him how he should structure his business. His friend told him there are three main types of **business organizations**: sole proprietorship, partnership, and corporation.

For the rest of this lesson, we will explore each type of business organization and explain the advantages and disadvantages of each.

Sole Proprietorship

The definition of **sole proprietorship** is a business owned by one person, hence the word sole, meaning one and only.

One advantage of a sole proprietorship is that the owner makes all the decisions. The owner is not obligated to confer with anyone when it comes to deciding the location of the business, who to hire, what to sell, etc. Another advantage to an owner of a sole proprietorship is that he or she is the recipient of all profits generated by the business. The owner is not legally bound to share the profits with anyone else.

While there are benefits to being a sole proprietorship, there are also drawbacks. One huge drawback is if the owner is sued, the owner is held personally liable. **Personal liability** means if the person or entity wins the lawsuit, the court can make the owner sell business and personal assets to satisfy the debt. Another disadvantage of this type of business organization is that when the owner dies, the business will become defunct or terminate. Now, let's see if a partnership can remedy some of these disadvantages.

Partnership

The attorney explained to Alvin that a partnership might be of interest to him. A **partnership** is a business owned by two or more people. One major advantage of a partnership is funding. Each owner can help with financing, start-up costs, or ongoing business expenses. Another advantage is shared knowledge and experience. In Alvin's case, he's good at making the widget, however, if he had a partner, his partner may have excellent selling and marketing skills to promote the widget.

However, one main disadvantage is that Alvin would need to share any profit with his partner. The percentage split would be agreed upon by each partner or may equal a percentage of what they put in to start the business. This same percentage would be applied if the business were sued; each partner would be liable to the percentage of ownership. Starting a corporation solves the personal liability issue of a sole proprietor and partnership.

Corporation

A **corporation** is a legal entity owned by shareholder(s). What's interesting about a corporation is that it can span from only one shareholder owning 100% of the corporation to the corporation being owned by thousands of shareholders, each defined by their percentage of investment.

Again, one main advantage of a corporation is the limited liability. If the corporation is sued, the liability is limited to the shareholder's investment. Alvin's personal assets cannot be attached. A corporation also allows for business continuity, meaning shares can be transferred or purchased by another shareholder in the event of death.

Despite there being many benefits to a corporation, there are also disadvantages. One is double taxation. If the corporation makes a profit, both the corporation and the shareholder must pay taxes (if profits are distributed to them). In essence, Alvin, as the shareholder, would need to file a personal tax return and the corporation would need to file a separate one.

Another disadvantage is cost. Starting a corporation is expensive, as the entity must be registered with the state. If the corporation is sued, an attorney must represent the entity.

Lesson Summary

There are three main types of **business organizations**: sole proprietorship, partnership and corporation.

A **sole proprietorship** is a business owned by one person. The advantages are: the owner keeps all the profits and makes all the decisions. The disadvantages are: personal liability and no possibility for business continuity.

A **partnership** is a business owned by two or more people. The advantages are: shared costs, knowledge and expenses. The disadvantages are: profit sharing and personal liability.

The next type of business organization is a **corporation**, which is defined as a legal entity owned by shareholder(s). A corporation solves the personal liability problem that a sole proprietorship and partnership present and offers business continuity in the event of a shareholder's death. However, two main disadvantages are double taxation and start-up costs.