Module 1.2: Sole Proprietorships

A sole proprietorship is the easiest and most common form of business to begin. It has one owner, who is responsible for all the transactions, decision-making, and debts of the business.

This is the format that most small businesses operate under as it is the most basic and informal form of conducting a business. It can have as many employees as necessary, but it can only have one owner. In fact, over 70% of American businesses are sole proprietorships.

You are not required to enter into any agreements or file any documents with the state to create a sole proprietorship. Businesses can also avoid a variety of legal fees and document filing fees that comes along with forming a business entity and generating the required corporate or partnership paperwork. There are no corporate board minutes to maintain, and no need to file separate income tax returns.

The most legal procedures you may have to do is to register your business name with the counties you do business in if you conduct your business under an assumed name such as 'Joe's Painting Company'.

Accounting is much simpler for a sole proprietorship. The sole proprietorship does not have a separate financial structure. What that means is although the business needs to keep its own set of bookkeeping, all of the financial assets and liabilities of the business are considered to belong to the individual owning the business. They are your personal assets and liabilities.

For instance, the sole proprietorship may borrow money to finance the business, but the business owner will be totally responsible for its repayment just like a personal loan.

As we will discuss further in module 2, not only should you keep separate sets of books for business and personal, but you should also set up separate banking accounts (checking, savings, loans) for the business. This creates a better audit trail to prove the deductions you take are for business expenses. Properly documenting your deductions may help reduce the owner's personal taxes, because the business taxes are part of your personal taxes as a sole proprietor.

Let's look at the other side of the coin. Because this business format is not incorporated, it can have unforeseen consequences that you should be aware of, so let's look at a few:

First, you can own a small business without even knowing you do. Too often, I have seen someone take a job that is considered an independent contractor and they do not realize what that means until they go to do their tax return. They enter the 1099-NEC information (instead of the W-2 they are used to) and suddenly discover that they owe hundreds of dollars in taxes instead of getting a refund.

I've actually had people sit at my desk and cry when I've had to tell them this.

There are a lot of unscrupulous people out there that take advantage of people this way. I really believe that it is unethical to not have an honest conversation with someone you are employing so that they know they will be responsible for their own taxes if you're not paying W-2 wages. (By the end of this training, hopefully, you will learn how to not be one of those unscrupulous business people.)

Second, the owner of a sole proprietorship is completely liable for anything their business does. This can come in the form of a lawsuit against the business which could strip you of everything you own. This could result in an IRS lien against your personal assets. These are nightmares you don't want to happen.

Third, because there is no legal separation between the business and its owner in a sole proprietorship, owners are held personally liable for the actions committed by employees of the business, if the act takes place within an employee's typical scope of employment.

To understand this issue further, let's take a look at the Texas Supreme Court case of Otis Engineering v Clark, that demonstrates how liability is created for an employer when an employee does something that the employee should reasonably anticipate could cause harm.

Otis Engineering Corp. v. Clark
Texas Supreme Court, 668 S.W.2d 307 (1983)

Matheson, who was an employee of Otis Engineering Corporation, had a history of being intoxicated on the job. One night he was particularly intoxicated, and his fellow employees believed he should be removed from the machines. Roy, his supervisor, suggested Matheson go home, then escorted him to the company parking lot and asked him if could make it home. He answered that he could, but 30 minutes later and about three miles away he caused an accident killing the wives of Larry and Clifford Clark.

The Clarks sued Otis in a wrongful death action, but the trial court dismissed the suit, holding that Otis could not be liable because Matheson was not acting within the scope of his employment at the time of the accident. The intermediate court of appeals reversed this, so Otis appealed to the Texas Supreme Court.

While the entire script of the court's judgement is an interesting read, they decided whether Otis acted as a reasonable and prudent employer by considering the following factors: there was a nurses's aid station on the plant premises, Otis could have made a phone to Mrs. Matheson, have another employee drive him home, and foresee the consequences of Matheson's driving upon a public street in his stuporous condition.

The take-away from this case is that if an employee acts unreasonably, while staying within the scope of their employment, their actions will create liability for their employer. Here, a supervisor sent a drunk employee to drive home, and under NO circumstances is that a reasonable choice.

If Otis had been a sole proprietor, they would have become Personally Liable for the harm caused by the choice to instruct a drunk employee to get behind the wheel of a car and drive home.

Personal liability is a serious issue and the major drawback of this format of business. Fortunately, there are a couple of things you can do to help protect yourself.

The first is to purchase an umbrella liability insurance policy. A million dollar policy is usually sold on an annual basis and they are reasonably priced.

Second, as we will discuss in module 1.4, you may form a single-member limited liability company (LLC). This gives you the benefits of limited liability, with the advantages of easier filing requirements.

Let's talk about Identification Numbers

A sole proprietorship may use the owner's social security or an employer identification number (EIN). However, I recommend that you obtain an EIN, so that you don't have to give out your personal social security number to vendors, etc. They are free to obtain and you will find the form at the IRS website. (https://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online.) I will put the link to this site in the transcript and in the section below this video.

In addition, the sole proprietorship MUST use an EIN if any of the following occurs:

- It has W-2 employees
- It files returns for excise taxes; or
- It has a qualified retirement plan

A sole proprietorship will cease when the owner ceases operating the business for any reason (sells, closes, dies, and so on), although the owner may have final tax filing requirements for the year it is closed.

If the owners decides to sell the business, it can't be sold as a lump sum. Each individual part of the business has to have a separate value set on it and sold individually.

So, let's review the Advantages and Disadvantages of a Sole Proprietorship:

Advantages are:

- Very easy and inexpensive to begin (may only need a business license)
- Owner has full control of all aspects of the business, from which type of work to do or what purchases that are made.
- No separate annual tax return for your business. Tax return is part of Form 1040, U.S. Individual Income Tax Return.
- Employees can be hired as the business grows.
- Owner can sell or transfer business assets at any time.

Disadvantages:

- Owner is liable for debts (including obligations for acts committed by employees).
- Self-employment tax must be paid on business profits over $400.
- Difficult to raise capital. (Owner must obtain loans based on their own credit.)
- Cannot be sold whole. Assets, licenses, etc. must be transferred individually.

So, while the sole proprietorship is the easiest to run, it is probably not the best choice in the long run. In the next module, we will be discussing the issues arising when you decide to go into business with someone else.