DOING BUSINESS AS A SOLE PROPRIETOR

The sole proprietorship is perhaps the most common form of business ownership. Conducting business as a sole proprietor has distinct advantages and disadvantages. You should be aware of these characteristics, as they can have a significant impact on your business. Please note that brief references appear in this article to corporations, another form of business ownership.

What is a sole proprietorship?

A sole proprietorship is an unincorporated business owned by one person (hence, the term sole). The owner of a sole proprietorship is known as a sole proprietor. If you conduct your business through a corporation, your business will not be a sole proprietorship. If you share ownership of your business with someone else, including your spouse, your business will not be a sole proprietorship.

The most important feature of a sole proprietorship is that the law makes no distinction between you, the sole proprietor, and your business. Virtually all the legal and tax consequences associated with sole proprietorships flow from this essential element.

As a sole proprietor, you can conduct business under your own name or under a trade name. For example, let's say I am a plumber. I can conduct business under my own name, Jim Poznak, Plumber. Or, I can conduct business under a trade name, such as EZ Flush. (Before using a trade name, you should read my article regarding trademarks, which appeared in the February, 1994, issue of Home and Small Business Reporter.) In either case--whether you conduct business under your own name or under a trade name--if you are the sole owner of an unincorporated business, your business will be a sole proprietorship, and you will be the sole proprietor.

A sole proprietorship can hire any number of employees. Because the law makes no distinction between you, the sole proprietor, and the business, you are not considered an employee. Sole proprietorships may also hire any number of independent contractors. (The difference between employees and independent contractors will be discussed in a future article.)

Whether you have zero or 100 employees (or independent contractors) makes no difference. If you are the sole owner, your business will still be a sole proprietorship.

Starting business as a sole proprietorship

Your sole proprietorship exists as soon as you start doing business. Let's return to our plumber example. As a plumber, my sole proprietorship starts to exist as soon as I do my first plumbing job. Consequently, the legal and tax implications of doing business as a sole proprietorship will also exist as soon as I do my first work as a sole proprietor.

The advantages of doing business as a sole proprietor

Conducting business as a sole proprietor brings two tax advantages. These advantages arise because the law makes no distinction between you and your business.

The first advantage is avoidance of double tax. What, you may ask, is double tax? Basically, double tax can occur if you conduct your business through a corporation rather than through a sole proprietorship. Corporations pay income tax separately from their owners. Double tax can occur when you (through your personal tax return) and your business (through its corporate tax return) must both pay taxes on the same dollar of income. We will examine the double tax problem more closely in the next issue of the Home and Small Business Reporter. For now, you simply need to know that as a sole proprietor, you will not pay double tax on your business income because the law makes no distinction between you, the sole proprietor, and your sole proprietorship. All your business income is treated as your personal income.

The second tax advantage of sole proprietorships is that you can deduct your business losses to the extent of your total income that you may have from all sources, including interest, dividends, and gains from the sale of nonbusiness property. Furthermore, if you are married and file a joint tax return, your business losses will also offset your spouse's income. Your ability to deduct losses as a sole proprietor may reduce your family's total income tax burden and may be particularly useful during a startup or downturn phase of your business.

The above tax advantage involving business losses is perhaps best illustrated by looking at your 1993 U.S. individual income tax return (Form 1040). I know--you hoped you'd never have to look at it again! But trust me; this will be a short, helpful exercise. First, look at Line 12 on your Form 1040. Line 12 instructs you to report the income or loss from your business. It also requires you to attach Schedule C. Now, compare the amount of income or loss that you reported on Line 12 with Line 31 from Schedule C. They are the same! Look at Schedule C again. The amount on Line 31 (and thus on Line 12) is the amount of your gross business income or loss

(Schedule C, Line 6) minus your total business expenses (Schedule C, Line 28). Class, the exercise is over. You may put your Form 1040 back in storage.

The disadvantages of sole proprietorships

In the "real world," every action has a reaction. In the "legal and tax world," every advantage has a disadvantage.

The principle disadvantage of sole proprietorships is that you, the sole proprietor, are personally liable for all the debts of your sole proprietorship. The reason for this is, once again, the law makes no distinction between you, the sole proprietor, and your sole proprietorship.

For an example, let's again assume that I am a plumber. While attempting to fix a pipe, I accidentally flood my customer's basement with sewage. I am personally liable for the damages caused by the flooding. This means that my customer can look to all of my personal and business assets to pay for the damage, including my bank accounts, my vehicles, my equipment, and perhaps even my house!

You can reduce your personal liability in several ways. If you are married and own your home with your spouse, you can shelter your house from personal liability by holding title with your spouse as tenants by the entirety rather than as joint tenants. You might also try to get a release from your customers. For example, as a plumber before starting on a job, I would ask my customers to sign a paper saying that they would not hold me responsible for any damage I cause, including damage caused by my negligence. Of course, customers may not want to sign such a release and you may not even want to ask for it. Another way may be to purchase insurance to cover potential damages, which you should do whenever possible. However, insurance may be costly, and not every risk is insurable. The best way to avoid personal liability may be to incorporate your business. This will be discussed in more detail next month.

A second disadvantage of conducting business as a sole proprietorship is that you may pay higher income taxes. I am sure you remember that as a sole proprietor you report your business income on your personal tax return (Line 12 on the 1040 again). While you do avoid double tax this way, if as a single person your total adjusted gross income exceeds $115,000, or as a married person filing jointly your adjusted gross income exceeds $140,000, you may pay income tax at the highest rate. By incorporating your business, you may be able to reduce your tax rate.

As a sole proprietor, you face two additional disadvantages. Starting in 1994, you cannot take any tax deduction for your health or life insurance. There is no good reason for this; the Internal Revenue Code just does not allow sole proprietors to take the deductions. A full deduction for your health insurance and a deduction for a $50,000 life insurance policy are available to corporations, so long as all employees of the corporation are offered the insurance. If these deductions will save you enough money, you may want to incorporate your business.

Conclusion

Every business is different. What may be advantageous to you may be disadvantageous to someone else. However, because significant tax and legal repercussions flow from your decision to conduct your business as a sole proprietor, you should be aware of them. By being aware, you can best avoid unexpected and unintended consequences.