The National Agricultural Law Center

Business Organizations Reading Room

Sole Proprietorships

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Introduction

The sole proprietorship is one of the simplest forms of business structures and is effective without any legal filings. Many businesses throughout the country function under this business structure even if they are completely unaware that their operation does have a business structure. Different states have some variation in their treatment of sole proprietorships, but the normal view is that the owner is the business. This means that for the purposes of lawsuits, taxes, permits, licenses and other such things, the individual who owns the operation will typically have everything in their name and they will be personally responsible for any actions taken on behalf of the business. The sole proprietor owns, controls, and is the individual that is legally responsible for the actions and debts of the business operation. Just as the individual owner is personally responsible for the debts of the business the creditors of the individual will be able to reach the assets of the business because of the close connection between the owner and the sole proprietorship.

Formation

Any individual who starts their own business or farming operation without further organization and filing is considered to be a sole proprietor. This is one of the two default types of business organizations that arise automatically when the business is created without the filing of organizational forms with a state government. The only requirements needed to form a sole proprietorship are that the business must be owned by a single individual and that no other valid business form was created by filing legal documents with a state government. While there is a requirement that only one individual may own the operation, an individual owner may hire as many employees as they wish with no impact on this business structure.

Liability

One of the most important characteristics of the sole proprietorship is that the owner is held personally liable for the actions and debts of the business. For this reason many businesses choose to create some of other business entity (such as an LLC or corporation) to own the business through to avoid personal liability if possible. The liability that the owner of a sole proprietorship faces is the same as if there is no business entity at all. The owner is completely responsible for the assets, debts, and actions of the business's employees. See the following examples

Example 1: A farmer operates his farm as a sole proprietorship part time and also works in town to supplement his income. The farm experiences a bad year and is unable to pay the bank with the proceeds from the crop. In this case the bank can garnish the farmer's wages from his job in town, foreclose on his farm if they have a mortgage, or reach almost any other asset that the farmer owns. The farmer is responsible for the debts of the farm and this responsibility even extends to non-farm assets.

Example 2: The same farmer from Example #1 except this time the farm is doing very well. In fact the farm is doing so well that the farmer must hire an employee to keep up with the extra work. This employee, during the course of work, causes an accident and severely injures another person. If the injured person sues the farmer and wins than the farmer is personally liable. This means that more than just the farm is at risk even though the person was injured by an employee of the farming operation. The wages earned in town as well as any other assets that the farmer has are at risk of being lost even though the farmer did nothing wrong himself.

Example 3: A farmer operates his farm as a sole proprietorship part time and works in town to supplement his income. The farm is doing exceptionally well and the farmer has hired 5 employees to help run the farm. One day after working at his job in town the farmer is heading home and causes a car wreck which severely injures another person. The car wreck has nothing to do with the farm and the injured person wins a huge judgment against the farmer. When it comes time to collect the judgment the injured party can go after the assets of farming operation as well as all other assets of the farmer. The fact that the farm had nothing to do with the car wreck and the fact that the 5 employees will undoubtedly lose their job does not matter since the farm is the property of the farmer.

This limitless exposure to risk makes the sole proprietorship an unattractive option for a business structure. As a result, many businesses either start under a different structure or they create a different structure once their business or other assets grow to the point where they are no longer willing to take the chance of putting all of their personal and business assets at risk

Tax Structure

Taxes for sole proprietorships are relatively easy since the business itself is basically ignored. Taxes are paid by the sole proprietor (often as self-employment taxes) and not by the business itself. The sole proprietor is personally liable for the payment of all taxes associated with running the business. While the owner is personally taxed for the income generated by the business they will also typically be able to deduct the expenses associated with operating the business.

Termination

The sole proprietorship business structure is not a form that is intended to go on indefinitely. Because of this there are several ways for a sole proprietorship to be dissolved. This form of business will end if the single individual that owns the business passes away or sells off the assets since this business form is tied directly to the individual owner. Another way to end a sole proprietorship is to bring in a partner. By definition there can only be one owner of a sole proprietorship and once ownership of the business is shared by two or more people than this business structure ceases to exist and another structure takes its place. Another way to terminate the sole proprietorship is to file the necessary paperwork with a state government to create a different business entity. A sole proprietorship is a default business structure that exists so long as no other business structure is in place. Once a formal business structure is legally created the sole proprietorship is replaced with the new business entity.

Conclusion

The sole proprietorship is essentially a fictitious entity. The profits, assets, debts, responsibilities, and liabilities of the business rest solely on the individual owner. Unlike other business structures, such as corporations or limited liability companies, there is no legal entity that is created to bear the responsibility of operating the business. The ultimate responsibility, whether for better or worse, rests entirely on the owner alone. There is nothing in place to shield the owner from the financial and legal consequences of operating the business and nothing is in place to shield the assets of the business if the individual owner suffers from financial or legal problems. The fortunes of both the business and the individual are tied together so closely that neither is likely to survive if a misfortune befalls the other.