



Protect Yourself from the Risks of a Sole Proprietorship

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This article begins a series of articles regarding selecting and forming the right entity for your business. We will begin with the simplest business form, the sole proprietorship.

So you're excited about your new business idea and can't wait to get started. You also don't have much money to invest in your business, so you're hoping to save on expenses wherever possible. Rather than making the investment to form a company, you're considering whether to wait to do so until you start making money, right?

This reflects the mindset of many new entrepreneurs who decide to operate their businesses as sole proprietorships. A sole proprietorship is a business that is owned directly by a single individual. It is the "default" business form for an entrepreneur who does not operate his or her business through a company.

Although it is common for new entrepreneurs to operate as sole proprietors, the decision to do so is risky. In a sole proprietorship, there is no legal distinction between the owner and the business, which makes the owner responsible for all of the business's debts. Unlimited personal liability represents a hidden but very real cost of operating a sole proprietorship, which in my opinion far exceeds the relatively small upfront cost of forming a company. For this reason, I strongly recommend that you operate your business through a company from the start.

Here is a summary of some of the disadvantages and (limited) advantages of the sole proprietorship.

DISADVANTAGES OF THE SOLE PROPRIETORSHIP

- **Unlimited Liability and Risk** -The owner of a sole proprietorship is personally responsible for all of the business's debts, which places his or her personal assets and future wages at risk. This is the number one reason to avoid sole proprietorships. Consider forming a limited liability company or corporation to shield yourself from most liabilities.

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- **Difficulty Raising Capital** -Because there are no shares of stock or membership interests to sell, sole proprietors have a difficult time raising capital from investors. Banks and other lenders are also sometimes hesitant to lend to sole proprietors.
- **Succession Planning** -It is difficult to plan effectively for the succession of a sole proprietorship to your heirs or a potential purchaser, due in part to the commingling of your business and personal assets.

LIMITED ADVANTAGES OF THE SOLE PROPRIETORSHIP

- **Simple** -Sole proprietorships are simple—all that is required is that you operate a business without a company, since it's the default option. Also, in Michigan you are required to file a notice with the clerk for the county in which your business operates every five years. Tax preparation is simple, as well—no company tax return is required. The sole proprietor simply reports the business's income and expenses on Schedule C, which is attached to his or her IRS Form 1040 return.
- **Inexpensive** -Due to the limited paperwork, there is little or no upfront cost to establishing a sole proprietorship. The hidden liability costs discussed above, however, can be expensive in the long run.

If you are thinking about starting a business, avoid the sole proprietorship in favor of establishing a company. Stay tuned for my discussion of your options, such as forming an LLC, "S" corporation or "C" corporation.

If you have questions about the best structure for your business, please contact Joel Farrar at 517-371-8305.