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Paul H. Gessaman

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Setting Up Your Own Business: The Sole Proprietorship

by Paul H. Gessaman, Extension Economist

This is one in a series of **NebFacts** providing information on the principal forms of business organization used by small businesses. A broad overview of the advantages, limitations, and tax implications of each form of business organization is included. Titles in the series are listed at the end of each NebFact.

Your need for legal and tax advice: While the information contained in this document is thought to be accurate, it should not be used as a substitute for legal advice on matters related to business organization, taxation, estate planning, or other business and financial management matters. Consult with your legal and tax advisers before making decisions.

Form of business organization:

The sole proprietorship is a popular and frequently used form of business organization. When your business is organized as a single proprietorship, the business entity and your other affairs (personal and business) are merged together. As the proprietor, you own and control the business. From the standpoint of nearly all legal rights and responsibilities, your sole proprietorship business and you, as the proprietor, are considered to be one and the same.

When a business is owned and operated by a wife and husband, it often is not clear whether the operation is a sole proprietorship or a partnership. Under some conditions, the distinction between a sole proprietorship and a partnership can be very important. If you have a sole proprietorship owned and operated by you and your spouse, ask your attorney to clearly identify the legal implications of the linkage between your personal and business affairs. Your attorney also can describe actions you can take to ensure that you have whatever liability protection is possible in your circumstances.

In a business organized as a sole proprietorship, the owner directs business activities and may supply all management and labor utilized by the business. However, employees can supply either or both without altering the nature of the sole proprietorship. All proprietorship debt is payable by the proprietor (proprietor's family unit), and lenders customarily require signatures on debt agreements by both the proprietor and spouse (if any). All profits accrue to, and all losses are borne by, the proprietor (the family).

For business and financial management purposes, it is best to maintain completely separate records for the business unit and the family or household. To ensure you have documentation needed for income tax reporting purposes, it's best to use separate bank accounts and separate credit arrangements for your business and your family affairs.

If credit is used in your business operations, it's particularly important to maintain the separation of finances and records for your business unit and your household. Interest payments on personal debt are not a deductible expense for federal and state income tax purposes while interest payments on business borrowing are fully deductible. When business and household costs are incurred jointly (for example: utility costs when you have a home-based business that's not separately metered, telephone bills when the telephone is used for personal and business calls, and travel using a personal auto for business purposes), allocate the respective portions to the business unit and the household. Then pay the business and personal amounts from the respective bank accounts. A relatively small investment of effort in bill paying and record keeping can ensure you have the data needed for filing and substantiating your income tax returns.

Advantages of sole proprietorship:

In large part, the popularity of the sole proprietorship results from its simplicity and flexibility. A sole proprietorship can be established, modified, bought, sold, or terminated very quickly. No business planning or organizational arrangements (bylaws, organizational charter, etc.) are required when a sole proprietorship is established; an approach that often works to the proprietor's detriment. Other than routine permits and licenses required for your business activities, neither public notification or legal assistance is required to start, terminate, redirect, or modify the business. The proprietor can decide to start a business and almost immediately can say, "I'm open for business and I'm my own boss."

The size or complexity of the business unit can be changed as the proprietor desires whenever there is financial capacity to do so. Children can be involved in both business and family activities as determined by their age, interests, abilities, and parents' wishes. Depending on personalities and interests, the involvement of family members in the business is relatively unrestricted.

Limitations of sole proprietorship:

The sole proprietorship has a number of limitations. Many result from the lack of a separate business entity. Even though there are many financial management and tax reasons not to do so, mingling of business and household finances and operating with a resource base that's primarily the family's net worth occurs in many sole proprietorships. The resulting limitations include:

- everything the proprietor and family own is at risk in both personal and business activities unless nonbusiness assets are protected in a trust or other isolating mechanism;

- the resource base of the business unit may be so limited that credit availability and capacity to respond to business opportunities is moderately to severely restricted;

- the business ends with the death of the proprietor and, if business activity is to continue, a new business must be established by the survivors;

- unless succession is carefully planned, each generation must purchase or inherit the business assets paying any applicable taxes and costs;

- mixing business and household finances can make it difficult to measure business financial performance and profitability, and may lead to loss of equity that is not recognized until the business is in serious financial difficulty;

- conflicts or disagreements within the family can immobilize the business unit and prevent needed decision making.

Tax implications – general:

All real property and personal property is taxable to the extent set by Nebraska law. Proprietor income is treated as individual income, is fully subject to state and federal income tax and, as applicable, to self-employment tax. Sales of capital items at prices above the unrecovered tax basis generate taxable income and state and federal income tax liabilities. (Currently, the capital gains tax rate for federal income tax purposes cannot exceed 28 percent, and 30 percent of the cost of health insurance premiums for self-employed persons is deductible when calculating federal adjusted gross income.)

Wages paid to employees are subject to payroll taxes in the same manner as is the case for employees in any other type of economic activity. Currently, wages paid by a sole proprietor to his or her children under age 18 are not subject to payroll taxes. In most cases a Federal Tax Identification Number should be secured and used on federal tax returns and reports.

Tax-reducing opportunities typical of small businesses can be used where applicable. Examples include: write-off of the business portion of the costs of vehicle ownership for vehicles used for both business and personal use, deductibility of business travel costs, and direct reporting of other business expenses on Schedule C of Form 1040.

Unless done very carefully, sale of part or all of the proprietor's ownership interests is likely to generate relatively large tax liabilities.

Gift tax and estate tax implications:

All aspects of the gift tax, estate tax, and inheritance tax are the same as those applicable to any individual. Gifting of tangible assets to utilize the nontaxable gift allowance of up to $10,000 (up to $20,000 for a joint gift by husband and wife) per recipient per year can be very difficult as assets with the correct value usually are difficult to identify. If such assets can be identified, gifting may be infeasible if these assets are important to the continued viability of the business.

Estate planning can provide a plan for minimizing the legal and tax costs of orderly transfer of your business and personal assets to successors. While everyone needs to have an estate plan in place, it's particularly important to do so if your equity in personal and business assets is greater than $600,000. Be sure to rely on the recommendations of your legal and tax advisers when completing your estate planning activities.

Cooperative Extension publications in this series:

- NF 96-253 *Setting Up Your Own Business: The Sole Proprietorship*
- NF 96-254 *Setting Up Your Own Business: The Partnership*
- NF 96-255 *Setting Up Your Own Business: The "S" Corporation*
- NF 96-256 *Setting Up Your Own Business: The "C" Corporation*
- NF 96-257 *Setting Up Your Own Business: The Limited Liability Company*

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