

Simplicity Versus Protection: a comparison of Partnerships and Corporations

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Two of the most common forms of business ownership today are the general partnership and the C-corporation (sometimes called a "regular" corporation). To better understand the advantages and disadvantages of each it may be instructive to compare some of the features of both of these forms of ownership. Formation of a partnership can be as simple as a verbal agreement among the partners that they will operate a business for profit. No forms are necessary. However, a partnership agreement is recommended to address such concerns as division of profits and losses, the amount to be invested by each partner, limitations to the agency authority of certain partners, and continuation of the partnership after the withdrawal or death of a partner.

In the absence of an agreement to the contrary, each partner is an agent for the partnership and can bind it (and the other partners) to contracts, debt and other liabilities. The partnership is an entity and holds assets as an entity. However, should some liability or calamity exhaust its assets each general partner is liable for all the debts of the partnership. The revenue earned or losses encountered by the partnership are apportioned according to the partnership agreement and flow directly to each partner and are taxed at his/her individual tax rate. There is no tax at the entity level. In the absence of an agreement to the contrary, the death, withdrawal or incapacity of one of the partners terminates the entity.

As a rule it can be said that the partnership has two primary advantages. It can be simple to create and it is subject to only one level of taxation. However, these advantages are often offset by the unlimited liability of each partner, a lack of tax write-offs for revenue disbursed to the partners, the limited life span of the partnership and difficulties that may arise regarding leadership. The corporate form of ownership can eliminate some of these disadvantages. However, the corporations are not without their own problems.

Probably the single most distinguishing characteristic of a corporation when compared to a partnership or a sole proprietorship is its status as a separate legal entity. In 1819 Justice John Marshall recognized a corporation as "an artificial being". As such, a corporation can enter into contracts, hold property in its own name and be taxed as a separate entity. Formation requires that documents (e.g. Articles of Incorporation) be filed with the state. In addition, once formed a corporation must observe certain formalities (e.g. annual stockholders meetings) in order to maintain its status as a separate legal entity.

Because it is a separate legal entity the corporation is responsible for its own contracts and liable for its own debts. Its officers (unless they are negligent or have signed guarantees or the like) are not liable for the acts or debts of the corporation. Investors, known as stockholders or shareholders, can lose their investment but cannot be held liable for the acts or debts of the corporation. The stockholders are the owners of the corporation. Their ownership rights are represented by shares of stock. Each share represents a percentage of ownership of the corporation. Often these stockholders "vote their shares" at the annual stockholders meeting in order to determine the leadership of the corporation.

The C-corporation has many advantages over the partnership. The leadership is well defined and the entity can last indefinitely. It does not dissolve if a stockholder dies or sells his/her shares. The liability of shareholders is limited to their investments. Even the officers of the corporation, if they are not negligent and are acting in good faith, may not be liable for acts committed by the corporation. Frequently, through the mechanism of issuing stock, the corporation can amass large amounts of capital which can be difficult for a partnership. Finally, because it is a separate legal entity, the corporation can deduct the costs of compensating its officers as a business expense which is something a partnership can not do.

These advantages are offset by two significant disadvantages. First, because it is a separate legal entity the corporation must pay taxes on its earnings. It then disburses its after tax earnings to its stockholders in the form of dividends. The stockholders must declare the dividends as income which is taxed a second time at their personal income tax rate. This phenomenon is often referred to as "double taxation" of corporate income. Second, compared to a partnership a corporation is both more difficult and more expensive to form and maintain.

If you would like to explore further, the various legal forms of ownership, please feel free to contact the ESU Small Business Development Center. The SBDC can be reached by calling 620-341-5308, via email at sbdc@emporia.edu or by visiting www.emporia.edu/sbdc.



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