Operating as a Sole Proprietorship

As the owner of a farm or food enterprise, you choose how you want to operate it. Choosing the right business structure is important because it affects many aspects of your company. For example, it can influence tax treatment, exposure to risk and liability, and personal control over the business. New farmers or food entrepreneurs often operate as sole proprietors. This legal guide discusses the features and obligations of operating your business is as a sole proprietorship.

I. What is a Sole Proprietorship?

A sole proprietorship is a business owned by one person, the sole proprietor. Anyone who operates a business as an individual – without having formed a separate entity – is a sole proprietorship. In a sole proprietorship, there is no separation between you personally and your business. Many farms and food enterprises start out as sole proprietorships because the structure is easy and convenient.

II. Benefits of a Sole Proprietorship

A sole proprietorship is one of the easiest business structures to form and operate. A sole proprietorship is created just by doing business. Typically, there are no requirements to file formation documents with the state or to comply with other formalities. As such, sole proprietorships require less time, effort and cost to establish and operate as compared to other business structures. However, there are disadvantages to sole proprietorships (as discussed below) that often outweigh these benefits.

III. Disadvantages of a Sole Proprietorship

As sole proprietor, you have personal liability for all obligations (debts) of the business. This means that your personal assets can be used to pay debts that the business itself cannot pay.

- For example, your farm does not make timely payments on a bank loan. Because you are personally liable for the farm's debt, the bank can seek payment from your personal assets, such as personal savings, a car, and possibly a home.

Additionally, lawsuits can be brought directly against the sole proprietor. And the the sole proprietor is personally liable for all of the business's actions.

- For example, a visitor to your pick-your-own-apples farm is injured and requires hospitalization. Because your business is not a separate entity, the injured visitor may sue you directly to get his or her medical bills paid.

Another disadvantage of a sole proprietorship is that it cannot have more than one owner. Once a business has two or more owners (and has not formed a legal entity such as a limited liability company or corporation), it becomes a general partnership.

Unlike corporations and limited liability companies, sole proprietorships cannot raise capital for the business through selling equity in the company.

IV. How to Set Up & Operate a Sole Proprietorship

The organization of a sole proprietorship is not typically governed by state or federal rules. The requirements for setting up a sole proprietorship are dictated by the city and local municipality where the sole proprietorship operates. If a sole proprietorship operates in multiple municipalities, he or she should comply with the applicable rules in each municipality.

Most cities and municipalities require a sole proprietorship to register the business. Generally, the name of the sole proprietorship is the legal name of the sole proprietor. However, a sole proprietor may elect to use a trade name or fictitious name — that is any name that is not the sole proprietor's legal name. If you operate your sole proprietorship under a trade name or fictitious name, then you will likely need to file "Doing Business As" (or "DBA") paperwork with the local government as part of registering the business. The local government will check to make sure there is no other business using this name in the area.

- As an example, in Massachusetts, you must file a business certificate identifying the assumed trade name or fictitious name of the business. The certificate is filed with the clerk's office of the local city or municipality in which the business operates. This business certificate must be notarized prior to filing with the clerk's office and must be renewed every four years.

Additionally, depending on the activities of your business, you will likely have to obtain other licenses, such as building occupancy permits, sales permits, board of health licenses, professional licenses, and so forth.

If your business has employees, you will also have to obtain a federal employer identification number ("EIN") and comply with employment tax withholding and reporting obligations. For more information and to apply for an EIN, please refer to the IRS website at irs.gov. You will also have to register as an employer with applicable state agencies and otherwise comply with state employment procedures and requirements. For more information on employment tax obligations, please see our *Payroll Tax* legal guide. For more information on employment procedures and requirements, please see our *Employment Law Guide*.

V. Income Tax Treatment

The sole proprietor reports business income or losses on his or her personal income tax return and pays taxes on any income.

- No separate income tax return is filed by the business.

- The use or distribution of the income does not affect income tax obligations. For example, the income could be paid to himself or herself, reinvested into the business or sit in the business's bank account.
- Business losses may be used to offset income obtained from other sources of income, subject to certain limitations.

The sole proprietor may be required to make estimated tax payments to the Internal Revenue Service (IRS) and applicable state taxing authorities. In addition, the sole proprietor's income from the business generally will be subject to self-employment tax.

For additional information on income taxes and self-employment tax, consult IRS Publication 334 (Tax Guide for Small Business), available on the IRS website at irs.gov. You should also consult your personal tax advisor.

VI. Conclusion

A sole proprietorship is the default business structure for a business that is owned and operated by a single person. In a sole proprietorship, the owner does not need to adhere to corporate formalities or make ongoing corporate filings with the state. As such, this structure can reduce time, effort and cost associated with operating your business. However, sole proprietors are personally liable for satisfying business obligations, which can be a significant disadvantage. As discussed, the steps for organizing a sole proprietorship vary by state, as well as at the local municipality level, so it is important that you check with state and local authorities to ensure you set up and operate your sole proprietorship properly.

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