



Virginia Cooperative Extension

Virginia Tech • Virginia State University

Graduate Extension Scholars Program

Understanding Business Structures, Markets, and Risk Management Strategies Handout 1.1 _____ Publication ALCE-177-B

Pretest With Answers

Answers from the U.S. Small Business Administration and accessed at the following websites:

<http://www.toryburchfoundation.org/resources/starting-a-business/>

<https://www.sba.gov/business-guide/launch-your-business/choose-business-structure>

Please give a short answer to each of the following questions.

1. List and describe the five business structures.

Sole proprietorship. Owned and run by one individual. Business is not taxed separately (sole proprietorship income is your income).

Partnership. Single business where two or more people share ownership. Must register business with state and establish business name in partner agreement.

Limited liability company. Hybrid of partnership and corporation. Choose business name, file articles of organization, and create operating agreement.

Cooperative. Business owned and operated for the benefit of those using its services. File articles of incorporation, create bylaws, develop membership application, conduct charter member meeting, and elect directors.

Corporation. Independent legal entity owned by shareholders.

2. How is an LLC different from a partnership?

An LLC combines the limited-liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Owners are referred to as members. Must file formal articles of organization with state; members not personally responsible for debts/liabilities (unless negligent).

3. What are the three types of partnerships?

General partnerships assume that profits, liability, and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.

Limited partnerships (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

Joint ventures act as general partnerships but for only a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

4. What are the advantages and disadvantages of a sole proprietorship?

Advantages of a sole proprietorship:

- *Easy and inexpensive to form. A sole proprietorship is the simplest and least expensive business structure to establish. Costs are minimal, with legal costs limited to obtaining the necessary license or permits.*

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Pretest With Answers (cont.)

- *Complete control.* Because you are the sole owner of the business, you have complete control over all decisions. You aren't required to consult with anyone else when you need to make decisions or want to make changes.
- *Easy tax preparation.* Your business is not taxed separately, so it's easy to fulfill the tax reporting requirements for a sole proprietorship. The tax rates are also the lowest of the business structures.

Disadvantages of a sole proprietorship:

- *Unlimited personal liability.* Because there is no legal separation between you and your business, you can be held personally liable for the debts and obligations of the business. This risk extends to any liabilities incurred as a result of employee actions.
- *Hard to raise money.* Sole proprietors often face challenges when trying to raise money. Because you can't sell stock in the business, investors won't often invest. Banks are also hesitant to lend to a sole proprietorship because of a perceived lack of credibility when it comes to repayment if the business fails.
- *Heavy burden.* The flipside of complete control is the burden and pressure it can impose. You alone are ultimately responsible for the successes and failures of your business.

5. What are the advantages and disadvantages of a partnership?

Advantages of a partnership:

- *Easy and inexpensive.* Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- *Shared financial commitment.* In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This could be beneficial in terms of securing credit or by simply doubling your seed money.
- *Complementary skills.* A good partnership should reap the benefits of being able to utilize the strengths, resources, and expertise of each partner.
- *Partnership incentives for employees.* Partnerships have an employment advantage over other entities if they offer employees the opportunity to become partners. Partnership incentives often attract highly motivated and qualified employees.

Disadvantages of a partnership:

- *Joint and individual liability.* Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- *Disagreements among partners.* With multiple partners, there are bound to be disagreements. Partners should consult each other on all decisions, make compromises, and resolve disputes as amicably as possible.
- *Shared profits.* Because partnerships are jointly owned, each partner must share the successes and profits of the business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

6. What are the advantages and disadvantages of an LLC?

Advantages of an LLC:

- *Limited liability.* Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability — members are not necessarily shielded from wrongful acts, including those of their employees.

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VT/0319/ALCE-177

Pretest With Answers (cont.)

- *Less record-keeping.* An LLC's operational ease is one of its greatest advantages. Compared to an S-corporation, there is less registration paperwork (<https://www.sba.gov/business-guide/launch-your-business/register-your-business>) and there are smaller startup costs.
- *Sharing of profits.* There are fewer restrictions on profit-sharing within an LLC. Members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC:

- *Limited life.* In many states, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. However, you can include provisions in your operating agreement to prolong the life of the LLC if a member decides to leave the business.
- *Self-employment taxes.* Members of an LLC are considered self-employed and must pay the self-employment tax contributions toward Medicare and Social Security. The entire net income of the LLC is subject to this tax.

7. What are the advantages and disadvantages of a cooperative?

Advantages of a cooperative:

- *Less taxation.* Similar to an LLC, cooperatives that are incorporated normally are not taxed on surplus earnings (or patronage dividends) refunded to members. Therefore, members of a cooperative are only taxed once on their income from the cooperative and not on both the individual and the cooperative level.
- *Funding opportunities.* Depending on the type of cooperative you own or participate in, there are a variety of government-sponsored grant programs to help you start. For example, the USDA Rural Development program offers grants to those establishing and operating new and existing rural development cooperatives (<https://www.rd.usda.gov/programs-services/rural-cooperative-development-grant-program>).
- *Reduce costs and improve products and services.* By leveraging their size, cooperatives can more easily obtain discounts on supplies and other materials and services. Suppliers are more likely to give better products and services because they are working with a customer of more substantial size. Consequently, the members of the cooperative can focus on improving products and services.
- *Perpetual existence.* A cooperative structure brings less disruption and more continuity to the business. Unlike other business structures, members in a cooperative can routinely join or leave the business without causing dissolution.
- *Democratic organization.* Democracy is a defining element of cooperatives. The democratic structure of a cooperative ensures that it serves its members' needs. The amount of a member's monetary investment in the cooperative does not affect the weight of each vote, so no member-owner can dominate the decision-making process. The "one-member, one-vote" philosophy particularly appeals to smaller investors because they have as much say in the organization as does a larger investor.

Disadvantages of a cooperative:

- *Obtaining capital through investors.* Cooperatives can suffer from slower cash flow because members' incentive to contribute depends on how much they use the cooperative's services and products. While the one-member, one-vote philosophy is appealing to small investors, larger investors could choose to invest their money elsewhere because a larger share investment in the cooperative does not translate to greater decision-making power.
- *Lack of membership and participation.* If members do not fully participate and perform their duties, whether it be voting or carrying out daily operations, the business cannot operate at full capacity. If a lack of participation becomes an ongoing issue for a cooperative, it could risk losing members.

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Pretest With Answers (cont.)

8. What are the advantages and disadvantages of a corporation?

Advantages of a corporation:

- *Limited liability. When it comes to taking responsibility for business debts and actions of a corporation, shareholders' personal assets are protected. Shareholders can generally only be held accountable for their investment in stock of the company.*
- *Ability to generate capital. Corporations have an advantage when it comes to raising capital for their business: the ability to raise funds through the sale of stock.*
- *Corporate tax treatment. Corporations file taxes separately from their owners. Owners of a corporation only pay taxes on corporate profits paid to them in the form of salaries, bonuses, and dividends, while any additional profits are awarded a corporate tax rate, which is usually lower than a personal income tax rate.*
- *Attractive to potential employees. Corporations are generally able to attract and hire high-quality and motivated employees because they offer competitive benefits and the potential for partial ownership through stock options.*

Disadvantages of a corporation:

- *Time and money. Corporations are costly and time-consuming ventures to start and operate. Incorporating requires startup, operating, and tax costs that most other structures do not require.*
- *Double taxing. In some cases, corporations are taxed twice — first when the company makes a profit and again when dividends are paid to shareholders.*
- *Additional paperwork. Because corporations are highly regulated by federal, state, and in some cases local agencies, increased paperwork and record-keeping burdens are associated with this entity.*

9. What do the phrases “going short” and “going long” in the futures market refer to?

- *Short-sell.*
- *Long-buy.*

10. If you are a seller of cattle, what could you do with the futures market to manage risk?

Buy a futures cattle contract at a low price and offset it at a higher price.

11. Give an example of a good or service that could be sold at a cooperative.

There are a wide range of answers that could be listed here. Within the agriculture industry, common examples include (but are not limited to): seeds, fertilizer, fuel, equipment and services such as marketing

12. What are three factors that influence the business structure a company chooses?

- *Shareholders.*
- *Decision-making style.*
- *Capital investments.*
- *Risk/liability.*
- *Taxation.*

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Pretest With Answers (cont.)

13. You grow corn in Virginia and sell it to a local grain elevator that usually sells this corn to Murphy Brown for pig feed. What are three tools you could use to determine when to sell your corn and get the best price?

- *Historical pricing: Barchart.com/Yahoo finance.*
- *Forward contracts.*
- *Storage.*
- *Hedging.*

14. Margie would like to start a business where she sells yarn. She would like to start by selling the yarn in her county and does not plan on selling in other states. She was planning on buying the wool from Tom, a sheep farmer, but he is also willing to go into business with her. Her son, Jack, has also offered to use his truck to pick up the wool and haul her yarn to the farmers market for a fee or a stake in her company. Wool and fuel prices have been going up, so Margie thinks there could be some benefits from not having to buy these inputs, but Tom can be stubborn, and Jack is thinking about starting a statewide hauling business. How should Margie form her business? Should Tom, Jack, and Margie all go into business together? What recommendations do you have for Margie as far as managing her business and minimizing her risk?

There are multiple correct answers to this scenario. Responses should accurately describe the advantages and disadvantages of the different business structures as outlined in the answers to the previous questions on this pre-test. The intent of this question is to get students thinking about application of the information to a complex scenario.