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*"The big print giveth, and the fine print taketh away."*

-Bishop Fulton J. Sheen

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## Forms of Ownership

### Characteristics

Choosing what legal form to use for one's business venture is important. The choice turns on the interplay of a number of considerations:

- o **Tax Considerations** -- there are two basic choices under the federal tax code:
    - ◆ **Personal** -- the business venture itself pays no income tax. The owners' personal tax returns directly include tax consequences for profits & losses of the business.
    - ◆ **Corporate** -- the business venture itself pays income tax on its reported profits directly to the IRS. The owners pay no taxes *until* the business pays profits out to the owners (dividends.)
    - ◆ **Double Taxation** -- Corporate forms of tax ownership results in double taxation of net profits earned by the business. (1) Pay corporate tax in the year the business earns profits; and (2) Pay personal tax (on the same net profits) again during the year that the business pays dividends to the owners.
    - ◆ **Maximum Corporate Taxes Rates** -- sometimes are higher than the maximum personal tax rates. Sometimes lower. Depends on the tax mood of the Congress. In 1999, the top personal rate was about 39%; the top corporate rate about 34%.
  - o **Exposure to Liability** -- some forms of ownership limit the liability of owners. Limited liability is useful in event of bankruptcy, lawsuits and faulty products.
  - o **Capital & Finance Needs** -- limited liability forms of ownership make it easier to raise equity capital from investors.
  - o **Business Goals** -- how big and how profitable will the business grow in the future? Bigger businesses often require a limited liability form of ownership. One can start with an unlimited liability form of ownership, and then switch as the business grows. But switching often is cumbersome, messy and expensive.
  - o **Management Succession Plans** -- difficulty in the smooth transfer of ownership. Succession matters in the event of the death or disability of the owner. Or in the event of a change in owners (where there is more than one owner in the first place.)
  - o **Cost of Formation** -- some forms of ownership are much more costly to create.
  - o **Hybrid Forms** -- have evolved to mix desired characteristics of basic ownership forms.
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### Sole Proprietorship

A business managed and owned by one person. About 75% of all US businesses.

#### Advantages

- o Simple to create
- o Profit Incentive (all mine!)
- o No special legal restrictions
- o Least costly to set up (buy a license)
- o Total decision-making authority
- o Easy to discontinue

#### Disadvantages

- o Unlimited personal liability
  - o Feeling of isolation
  - o Lack of continuity
  - o Limited managerial skills
  - o Limited access to investment capital
  - o Not suitable for large businesses
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### Partnership

- o An association of two or more people who co-own a business. Respect, mutual trust.

#### Advantages

- o Easy to establish
- o Division of profits -- simple
- o Can attract limited partners
- o Flexibility
- o Complementary skills
- o Increased capital
- o Little government regulation
- o No double taxation

#### Disadvantages

- o Unlimited liability for GP's
- o Difficult to transfer ownership
- o Decision-making conflicts
- o Difficult to accumulate capital
- o Lack of continuity
- o No access to public equity market

- o **Partnership Agreement** -- a MUST HAVE. The Agreement specifies:

- o General purpose of the business,
- o Ownership percentages and profit sharing arrangements,
- o When and how partners can invest or withdraw money,
- o Non-cash contributions, salaries and "draw" rights,
- o Procedures for expansion (new partners) or for contraction,
- o Duration of the partnership, dissolving the business, selling the business.

Like some marriages, **initial best intentions do not always work out**. A partnership agreement should be like a pre-nuptial agreement. Specify in writing how the partners will handle future disputes and how and when the partners can exit the arrangement.

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## Corporation

A separate legal entity apart from its owners, created under state law. An artificial person.

### Advantages

- o Limited Liability
- o Continue indefinitely
- o Can grow very large
- o Ability to attract capital
- o Transferable ownership
- o Access to public equity markets

### Disadvantages

- o Cost & time to incorporate
- o Potential loss of control
- o Employee incentives
- o Double taxation
- o Legal and red tape requirements
- o Extra taxes on issuance of shares

## Hybrid Forms of Ownership

- o **Subchapter “S” Corporation.** Similar to a regular corporation (called a “C” corporation.) In 1945, the IRS created “S” corporations, taxed like partnerships. Restrictions include: (a) must be a domestic company, (b) no foreign owners, (c) only may issue common stock, (d) no more than 75 shareholders.
  - o **Limited Partnership.** Similar to a general partnership except the partnership includes Limited Partners (“LP’s”). LP’s have a limited liability (equal to their \$ investment.) LP’s may not participate in managing the business. Money partners. A Limited Partnership must have at least one General Partner (unlimited liability) who invests at least 1% of the total capital. Most Venture investment funds are Limited Partnerships. The General Partner often itself is a corporation or another Limited Partnership.
  - o **Limited Liability Company (LLC).** A cross between a partnership and a corporation. Owners are, “Members”. Taxed like a partnership, with but with limited liability for all the Members. No restrictions of the “S” corporation: an LLC can have more than 75 members, including overseas members, etc. The Members can participate in the management of the business. Many CPA firms are LLCs.
  - o **Master Limited Partnership.** A special kind of Limited Partnership that can go public with its shares traded on a stock exchange. Since 1987, restricted to natural resource or real estate ventures.
  - o **Professional Corporation.** A form of corporation where one owner may not be sued for another owner’s malpractice. Popular with doctors, architects and accountants.
  - o **Joint Venture.** Can take many legal forms, but JVs target a specific limited purpose, such as developing a biotech drug or drilling for oil in the North Sea.
  - o **Franchising.** Semi-independent owners (franchisees) pay fees and royalties to a parent company -- in return for the right to sell its products or services and to use its business format and system. Franchises account for 40% of retail sales: \$900 billion.
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