Keir's Digest

with

Assessment Questions

HS 331

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Planning for Business Owners and Professionals,
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Learning Objectives

1 - 1 A business can choose among several forms of organization. The unincorporated forms include the sole proprietorship, the partnership, the limited liability company, the limited partnership, and the limited liability partnership. Two incorporated forms are the regular C corporation and the S corporation. The choice of ownership form affects start-up costs, management control and flexibility, taxation, ability to raise capital, and the liability of the owners.

Start-Up Costs

Significant differences may arise in the formalities required to start a business. For a sole proprietorship, a formal agreement need not be drafted. However, a partnership should have a formal written agreement, called the articles of partnership. It is usually advisable to seek legal assistance in the preparation of this agreement. Although a general partnership may be formed without having a formal written agreement, state laws mandate a written agreement for the formation of a limited partnership.

To form a corporation, state laws of incorporation regulate the process. Articles of incorporation and bylaws must be drafted and filed with the state; stock certificates must be issued and distributed; and employment contracts must be prepared. Subscription agreements with the original stockholders must be prepared unless the original stock is to be issued by an underwriter, which requires further formalities. Moreover, there are filing fees and possibly taxes to be paid to the state. Legal and other professional assistance in completing the incorporation process can be expensive.

To form a limited-liability company (LLC), members file articles of organization with the state, and they adopt an operating agreement to set forth the detailed arrangements under which they will function. Costs associated with starting an LLC are usually higher than for a simple corporation.

Control and Flexibility of Operations

The control and flexibility of the owners in operating a business will vary according to the ownership form. In sole proprietorships, the proprietor needs and typically has maximum flexibility. Since there are no other owners, the proprietor's actions are generally unrestricted, though, obviously, a sole proprietor must obey local, state, and federal laws.

Partnerships also provide substantial flexibility but not as much as with the sole proprietorship. General agreement of the partners is necessary for all major business decisions. Also, the partnership agreement may limit the type of enterprise in which the firm may engage. However, the partnership agreement may be rewritten with the approval of all the partners.

In limited-liability companies (LLCs), control of the business may be limited to certain members, so not all owners will participate in management and control of the business. The owners have flexibility in designing the original operating agreement, so the owners can select the way in which the company will be managed, the compensation for officers and others, and other operating characteristics. Generally, the operating agreement can be amended only by agreement of all members, unless otherwise provided in the operating agreement.

Control over the business management of a corporation is the responsibility of the board of directors. The board is elected by the shareholders and may be dominated by the majority shareholder. The influence and composition of the shareholder group may be affected, should a transfer of existing stock or the issuance of new stock take place.

The corporate form provides the least amount of flexibility. First, corporate powers are limited by the original charter. Further, major actions must be approved by the board of directors and possibly the shareholders, as well. This limits the flexibility of management significantly because actions may only be authorized by the board of directors and the stockholders at specific times. However, in some states, closely held corporations are permitted increased flexibility similar to that of the sole proprietorship or partnership. Obviously, if there are only two or three officer-stockholders, flexibility may be the equivalent of a small partnership.

Business owners anticipating a large capital expansion may prefer a limited partnership over a general partnership. One reason for this is that in a limited partnership, the regular or general partners may sell passive investment or limited partnerships to raise capital, without diluting the control of the general partners. Further, a limited partnership may be more attractive to investors since they may receive a share of further income and growth; at the same time, their personal liability is limited to the amount of their invested capital.

Liability for Business Operations

Limited liability refers to the limitation of a business owner's personal responsibility for the legal liabilities and debts arising from operations of the business enterprise. Personal liability is limited to the amount of capital which the owner has invested.

The corporate form of ownership provides shareholders with limited liability because the owners cannot lose more than the amount of their investment and cannot be held personally liable for the debts of the business. As previously mentioned, the passive investors or limited partners in a limited partnership also enjoy limited liability. All limited partnerships must have at least one general partner who has unlimited personal liability. Limited-liability companies are a new business form, allowing all members to invest and be protected by limited liability. Limited-liability partnerships, another new development now available in all states, also provide liability protection for all partners.

Even though shareholders have limited liability, these owners may lose their protection from personal liability by taking certain actions. For example, an owner of a closely held corporation may be forced to take personal risk to obtain trade or bank credit for the firm. The owner or shareholder may be asked to give a personal guarantee for a loan to the corporation. Also, a professional in a practice is always subject to personal malpractice liability. Other corporate shareholder-employees may be held personally liable for their own actions.

A small business that does not require much capital can be organized efficiently as a sole proprietorship or a partnership. A business that needs to raise capital for expansion or revitalization will usually organize as a corporation or, sometimes, a limited liability partnership. These business forms allow for greater ease of transfer of ownership, continuity of the business, and limited liability that make ownership attractive to investors.

The following are the disadvantages of the proprietorship for a growing business: (a) The proprietorship's growth is limited to the growth that can be financed by the proprietor's own funds or the funds that can be borrowed. (b) Other types of business organizations (such as corporations) are separate legal entities and thus can issue securities in their own names, which a proprietorship cannot do.

Assignment 1

Common Business Problems and Planning Objectives

1. The choice of the form for a business organization will have an impact on which of the following?

(K 1.2)

I Start-up costs
II Taxation of the business and its owners
III Ability to raise capital

(A) I only (C) II and III only
(B) I and II only (D) I, II, and III

2. Which of the following business entities is not required to make a filing with the state when it is formed?

(K 1.3-1.4)

(A) An S corporation
(B) A limited-liability company
(C) A general partnership
(D) A professional corporation

3. Corporate control can be more complex than the control of the unincorporated company. Which of the following statements concerning corporate control is (are) correct?

(K 1.5)

I Control is vested in the board of directors.
II Shareholders vote for the board of directors.
III A majority shareholder cannot dominate the board of directors.

(A) I only (C) I and III only
(B) I and II only (D) I, II, and III

4. In general, which of the following represents the ranking of flexibility in business operations from highest to lowest?

(K 1.6-1.7)

I Sole proprietorship
II Partnership
III Closely held corporation
IV Large corporation

(A) I, II, III, IV (C) II, I, IV, III
(B) IV, III, II, I (D) I, III, II, IV

5. Most small businesses have a limited ability to raise capital. Which of the following statements concerning the sole proprietorship is correct?

(K 1.7-1.8)

(A) A proprietor usually does not put his or her own assets into the business.
(B) A proprietorship cannot raise funds by bringing in new owners, without changing the form of the business.
(C) The amount of credit available is usually unrelated to the proprietor's personal financial position.
(D) Very wealthy individuals are most likely to form sole proprietorships.

6. Which of the following statements concerning limited partnerships is correct?

(K 1.8)

(A) There are no general partners in a limited partnership.
(B) The limited partners may be risking more than the capital which they have invested in the business.
(C) Limited partnerships can raise capital by selling limited partnership interests, without diluting the general partners' control of the business.
(D) Limited partners cannot receive a share of future income and growth since their liability is limited.

Assignment 1

Common Business Problems and Planning Objectives

1. D is the answer. Start-up costs, taxation of the business and its owners, and the ability to raise capital will all vary, depending on whether the business is a sole proprietorship, partnership, regular corporation, or S corporation.

2. C is the answer. A general partnership and a proprietorship are the easiest business entities to form. No filing with the state is required. For limited partnerships and limited-liability companies, a filing with the state is required. All kinds of corporations also require a state filing. There are usually fees involved with such filings.

3. B is the answer. Control of a corporation is vested in a board of directors that is elected by the shareholders. A majority shareholder can effectively dominate the board.

4. A is the answer. The sole proprietor has the most flexibility in making decisions because the sole proprietor does not have to consult anyone before undertaking business operations or making business decisions. Partnership decisions require the agreement of all partners, but corporate actions are limited by the necessity for the board of directors to meet and vote, as well as by the corporate charter and bylaws. A large corporation will experience more delays and greater difficulty in following corporate procedures than will a closely held corporation.

5. B is the answer. By bringing new owners into a business, a sole proprietor must change the form of the business to a partnership or corporation. Credit is more readily available if the sole proprietor has substantial personal wealth, which can be reassuring to potential creditors. Wealthy individuals are more likely to form corporations than sole proprietorships because the limited-liability feature of the corporation will serve as protection for the person's accumulated wealth.

6. C is the answer. Limited partners are only passive investors and may take no part in management, so general partners have control of operations. However, limited partners have a right to receive a share of the firm's future income and appreciation.