

OVERVIEW OF BUSINESS PROBLEMS AND BUSINESS PLANNING OBJECTIVES (331-1)

Obj 1-1. SEVEN FORMS OF BUSINESS ORGANIZATION:

1. **Sole proprietorship**--is created, owned, and operated by one person.
The business is *not* a separate legal entity.
2. **General partnership**--is “an association of two or more persons (formed) to carry on as co-owners of a business for profit” (Uniform Partnership Act--**UPA**) with each person bearing *unlimited* personal liability for partnership obligations.
3. **Limited partnership**--includes at least one limited partner and at least one general partner.
A **limited partner** contributes tangible assets to the partnership, bears liability for partnership obligations *only up to* the value of his invested capital, *and* shares in its profits and losses, *but* has *no* right to bind the partnership *or* participate in its management.
A **general partner** can bind the partnership, bears unlimited liability for partnership obligations, *and* manages the business.
4. **Limited liability partnership (LLP)**--provides all partners with reduced liability for acts of other partners.
5. **Limited-liability company (LLC)**--offers the business owners (members) limited liability and ‘pass-through’ tax advantages.
6. **Regular (C) corporation**--is a *separate* legal entity owned by stockholders who bear *no* personal liability for corporate acts beyond the potential loss of their investments.
A **closely held corporation** is held by one person or a small group of people.
7. **S corporation**--combines the limited liability of a corporation with the ‘pass-through’ tax advantages of a partnership.

[Note: Those seven forms of business organization are discussed in greater detail in Chapters 2 and 3.]

SIX CONSIDERATIONS WHEN CHOOSING THE FORM OF BUSINESS ORGANIZATION:

1. **Start-up costs and operating formalities**--A proprietorship or partnership might have to register its business name with state regulators. A proprietorship is formed when the owner starts conducting business. A partnership should be formed with a formal partnership agreement drafted by an attorney (even though the agreement is not legally required). Corporations and LLCs are governed by statutory formalities that dictate specific required procedures and costs.
2. **Control**--A proprietor has total control of his business. Each partner has authority to make partnership decisions and to bind the other partners. Control of an LLC is determined by its operating agreement. A corporation’s board of directors oversees management of the corporation. The power of a corporation’s president is limited to ordinary business operations. The majority shareholder of a closely held corporation often controls the corporation.
3. **Flexibility**--A proprietor has the most operating and management flexibility. Although partnerships offer a significant amount of flexibility, any major business decisions require agreement by all the partners. An LLC’s management and compensation is dictated by its operating agreement. A corporation’s powers are limited by its charter.
4. **Ability to raise capital**--A proprietorship’s assets are limited to the proprietor’s personal assets and personal loans. Partners can supplement their assets and loans by adding additional partners. Limited partnerships can sell partnership interests to limited partners, thereby raising capital without diluting the existing partners’ control.
A corporation can borrow in its own name or sell additional shares of stock.
5. **Personal liability of owners**--Proprietors and general partners have unlimited personal liability for business debts. Limited partners, partners in an LLP, members in an LLC, and corporate stockholders have limited liability (up to the amount of the investment). *[Note: An individual (even an employee) bears primary personal liability for his own negligent acts in any business.]*
6. **Tax considerations**--are discussed in Obj 1-2.

Obj 1-2. **BASIC TAX TREATMENT OF BUSINESS ENTITIES:**

1. **Sole proprietorships**--are *not* separate legal entities and do *not* file tax returns. Net income, *after* deductible business expenses, is taxed to the individual owner as self-employment income.
2. **Pass-through entities**--include partnerships, LLCs, and S corporations. Pass-through entities have *separate* entity status for tax-accounting and reporting purposes, *but* they avoid double taxation by letting the company's income 'pass-through' to individual members to be taxed at their individual rates.
3. **Corporations**--are *separate* legal entities with their *own* tax status and tax rates. Corporate rates are generally lower than individual maximum rates. Shareholders are taxed on corporate earnings *only* when the earnings are distributed. A corporation equally owned by its shareholders can minimize overall taxes through income splitting, in which the corporation retains income for later distribution to its shareholders. **A highly compensated professional benefits from incorporation when the professional's maximum tax rate exceeds the flat tax rate for personal service corporations.**

Obj 1-3. **BUSINESS-CONTINUATION PROBLEMS:**

1. **Death of a business owner**--
 - a. **Sole proprietorship**--terminates by operation of law at the death of the proprietor. The business assets are included in the proprietor's estate.
 - b. **General partnership**--terminates by operation of law upon the death of one of the partners. The deceased partner's estate must be paid fair value for the partner's interest.
 - c. **Limited partnership**--terminates by operation of law upon the death of a *general* partner. The death of a *limited* partner has *no* legal effect on the legal continuity of the partnership.
 - d. **Corporation**--continues as a legal entity after the deaths of any or all of its individual shareholders. But, if the corporation depends on the personal services of a particular shareholder, the death of that shareholder may force the business to terminate. The death of a minority shareholder in a closely held corporation usually does *not* create a continuity problem, *but* his shares will probably have to be sold at a discount *and* the new minority owner may have goals contrary to those of the existing shareholders.
2. **Disability of a business owner**--A proprietorship or partnership will *not* terminate by operation of law upon the disability of an owner. But, the business must replace the owner's services and continue to pay a salary to the owner. A disabled proprietor, partner, or majority shareholder has the power to dissolve the business if he is not satisfied with his disability income. Business continuation planning is essential because, at pre-retirement ages, business owners face a significantly higher probability of disability than of death.
3. **Retirement of a business owner**--Retirement of a business owner creates issues similar to those created by death or disability. But, business owners are more likely to plan for retirement.
4. **Loss of a key employee**--In addition to the owners, many businesses also have at least one **key employee** who possesses specific skills, client contacts, or other characteristics that make him a valuable asset to the business [*ie, worth more to the business than he is paid by the business*]. Loss of a key employee could result in lost customers and lost income.

ADVERSE CONSEQUENCES OF BUSINESS TERMINATION:

1. **Lost income**--If the business terminates, income from the business ends.
2. **Lost professional advancement**--If surviving co-owners and key employees have unique skills tailored to the terminated business, they may have difficulty continuing their career paths.
3. **Discounted liquidation values**--The forced sale of a business or the liquidation of its assets often produces unsatisfactory proceeds because it is hard to find a buyer on short notice and the business has just lost one of its most valuable assets (its owner).

Obj 1-4. **COMPENSATION OF OWNERS:**

1. **Proprietor**--is entitled to all business profits.

The proprietor is taxed on all profits regardless of whether the profits are

- a. retained for personal use *or*
- b. reinvested in the business.

2. **Partners**--have the right to all partnership income.

The partnership agreement specifies the method of allocating profits among partners but the IRS requires each partner's distributive share to reflect his

- a. relative services *and/or*
- b. capital contributions.

The partners determine the portion of the distributive share to reinvest in the partnership.

The reinvested portion of the distributive share of partnership income is still taxable to the partners, but it increases their tax bases in their partnership interests.

Each partner's actual share is determined at the end of the partnership's fiscal year.

Partnerships make periodic distributions (**draws**) to the partners.

At the end of the fiscal year, the draws are compared to the partners' distributive shares.

Partners whose draws are *less* than their distributive shares receive additional payments.

Partners whose draws are more than their distributive shares must either

- a. reimburse the partnership *or*
- b. decrease their capital accounts.

3. **Members of an LLC**--follow the partnership rules *if* the LLC qualifies for partnership tax treatment.

4. **Shareholder owners**--may be compensated by any combination of

- a. cash (salary or bonus),
- b. fringe benefits, *and/or*
- c. dividends.

Reasonable compensation (salary or bonus) is tax deductible by the corporation and therefore is only taxed once.

Dividends and excess compensation are nondeductible by the corporation and therefore are taxed twice--once to the corporation when earned and once to the shareholder when received.

*[**Compensation planning** maximizes the usefulness to owners and key employees of any income earned by the business.]*

Obj 1-5. **RISK EXPOSURES OF A TYPICAL CLOSELY HELD BUSINESS:**

1. **Property loss exposures**--are evaluated in two parts:

- a. **property subject to loss**--includes all property under the ownership, use, and/or control of the business, including

- 1) **real property** (land and its attached structures; what you'd leave behind if you moved) *and*
- 2) **personal property** (all other property not attached to land, including *both*
 - a) **tangible** (touchable) property such as antiques and file cabinets *and*
 - b) **intangible** (not touchable) property such as copyrights and business ownership interests; what you'd take with you if you moved) *and*

- b. **causes of loss**--how the property can be damaged, destroyed, or lost.

Direct loss results from physical damage to, destruction of, *and/or* loss of physical control over property.

Direct loss includes reduction in property value and increased repair or replacement costs.

2. **Consequential loss** (aka **indirect loss**, *know both*)--results from direct loss and often causes
 - a. **lost income--decreased gross receipts including**
 - 1) **business interruption**--lost revenue during suspension of operations while damaged business property is repaired or replaced *and*
 - 2) **dependent-business interruption**--lost revenue resulting from damage to others' property including suppliers or customers *and*
 - b. **extra expense**--extraordinary expenses incurred to continue operations after a loss, such as renting alternative facilities, paying overtime, paying for expedited shipments, and paying to communicate details of new addresses and phone numbers with customers.
3. **Liability exposure**--is the possibility that the business will be required to indemnify a third party for injury caused by activities for which the business is legally liable.
 Liability can arise from injuries on the premises, improper acts of agents and employees, defective products, use of automobiles, professional malpractice, improper acts of officers and directors, *and/or* **personal liability** (unusually defined in this course as defamation, false arrest, or invasion of privacy.
[That definition usually applies to personal injury.]
4. **Personnel exposures**--include possibilities of loss related to employees.
 - a. **Workers' compensation (WC)**--refers to statutes that require fixed awards and medical reimbursement to employees and their dependents for employment-related injuries and illnesses.
 WC laws impose **strict liability [and statutory liability]** (liability without regard to fault [*by statute*]) on employers for injuries to employees but *not* injuries to independent contractors.
Most states *exclude* farm workers, domestic employees, *and* casual employees.
Some states exclude employees of small businesses.
 Workers outside the scope of WC laws still retain their right to sue their employers under common law.
 - b. **Death or disability of a key employee**--may result in decreased income and/or increased expenses.
 If the employee's skills are irreplaceable, the business may suffer irreparable damage.