Factors to Consider when Choosing a Business Form

- **Ownership and Control**
  - (owners want to control how their businesses are operated)
- **Liability**
  - (shielding personal assets from liability for corporate debts)
- **Taxation**
  - (On which level will it be taxed?)
- **Expenses involved in formation**
  - (i.e. legal bills)
- **Capitalization**
  - (getting money for the business to operate and grow)
- **Liquidity**
  - (ability to resell shares of the company)

The Sole Proprietorship

- Business owned by a single person
- No formation requirements at all… just open the doors and start operating
- Can contain employees; but one person has complete ownership and all decision making power
- **Taxation:**
  - All profits are considered personal income of the sole proprietor; there is no separate entity of the business itself
- **Liability:**
  - Proprietor is fully liable for all corporate debts

Sole Proprietorship

- **Advantages:**
  - Total control
  - Simplicity of Formation
- **Disadvantages**
  - Difficulty in raising capital
  - Unlimited Liability of owner for business debts
  - Very low liquidity in ownership of the business

General Partnership

- One or more people have ownership stakes in the business
- Partnership is a contract; so each party to the partnership must have the capacity to form a binding contract
- A partnership is considered its own entity for some, limited purposes; but primarily, a partnership is the sum of the ownership parts
- Partnership agreements can be oral; but the best advice is to put it in writing
- Partnerships can be implied be a court if the partners held themselves out to the public as partners (partnership by “estoppel”)
- **Single taxation**
- similar to sole proprietorship in terms of liquidity and capitalization
- **VERY UNSTABLE**; As soon as any partner leaves the partnership, the whole partnership automatically dissolves

General Partnership – Default Rules

- **Each partner has an equal ownership and control interest**

- **Upon dissolution:**
  - First, all debts get paid off from business money
  - Second, partners' investments of capital get paid back
  - Left over money is split; with each partner getting his pro-rata share based on ownership interests

General Partnership - Example

- **EXAMPLE: Bart Lisa and Maggie have a partnership with no written partnership agreement that calls for anything specific to happen upon dissolution. Bart contributed $500,000 to the partnership, Lisa contributed $300,000 and Maggie contributed $100,000.**

  - If the partnership dissolves with $1,500,000 in the bank and no debts, how much will each party receive?

  - If the partnership dissolves with no assets or debts, what will happen between the parties?

  - The partnership dissolves with no assets and $1,200,000 in debts, who must pay what portion of the debt?

Answer to Partnership Dissolution Problem

- **Scenario A:**
- Each partner gets back his or her investment; then they split the remaining $600,000 equally; so
  - Bart gets $700,000 ($500,000 originally invested plus his $200,000 share)
  - Lisa Gets $500,000 ($300,000 originally invested plus his $200,000 share)
  - Maggie gets $300,000 ($100,000 originally invested plus his $200,000 share)

QUIZ TIME!

Answer to Partnership Dissolution Problem (cont.)

- **Scenario B:**
- Although there is no money in the partnership account, the original investments are “debts” of the partnership. Since there are $900,000 in such “debts,” the partners must equally contribute toward that amount; So:
  - Bart receives a net of $200,000 ($500,000 he receives minus $300,000 he must contribute)
  - Lisa breaks even ($300,000 she receives minus $300,000 she must contribute)
  - Maggie must pay $200,000 ($100,000 she receives minus $300,000 she must contribute)

Answer to Partnership Dissolution Problem (cont.)

- **Scenario C:**
- The partnership debts total $2,100,000 (the $1,200,000 in debts plus $900,000 in original contributions that must be paid back), which must be contributed equally. So:
  - Bart must pay $200,000 ($700,000 for his share of the $2,100,000 debt minus the $500,000 he receives as his initial contribution)
  - Lisa must pay $400,000 ($700,000 for her share of the $2,100,000 debt minus the $300,000 she receives as her initial contribution)
  - Maggie must pay $600,000 ($700,000 for her share of the $2,100,000 debt minus the $100,000 she receives as her initial contribution)

Limited Partnership

- Designed to keep the control, taxation and simplicity benefits of the partnership; while eliminating the problem of unlimited liability that plagues ordinary partnerships
- Requires a filing with the state (unlike the general partnership)

- **Split into 2 groups:**
  - General Partners: The “controllers”; they have the management function in the company and have unlimited liability; like other general partnerships
  - Limited Partners: The “investors”; they have no (or very limited) management functions and have limited liability (they cannot lose more than they invested)

Limited Partnership – Other Issues

- The Limited Partnership not dissolved automatically by the transferring of interest to a third party. Still, it’s a pretty illiquid investment because it’s hard to get a secondary market for shares in small partnerships.

- Taxation is same as with the general partnership and sole proprietorships (each partner is responsible for his or her taxes on his or her profits).

- Capitalization is easier that in a general partnership because people can invest without working at the business or assuming liability for partnership debts.