Short summary # 15: Legal Forms of Business

The EY award recognizes the unstoppable entrepreneurs who have shown incredible resilience to unlock new opportunities during uncertain times.

Vellayan Subbiah, Chairman, Cholamandalam Investment and Finance and Executive Vice Chairman, Tube Investments of India on **winning the EY World Entrepreneur Of The Year 2024** award

JSW head **Sajjan Jindal,** *'Man of Steel'*, won the coveted EY Entrepreneur of The Year Award 2023 title and **among 2025 finalist.**

A business is a legal entity. ***A legal entity refers to any business, organization, or individual that's required to meet legal obligations as set by local, state, and federal laws. Think of it as a separate "person" in the eyes of the law. It can own property, sign contracts, sue or be sued, and be held accountable for its actions.***

One way of classifying businesses is based on the liabilities of the owners (shareholders) of the business in the event of liquidation. Owners may have:

i. Unlimited liabilities (A creditor may have the right to sell the personal properties or assets of the business owner to recover debts owed by the business.)
or

ii. Limited liabilities (A creditor do not have the right to sell personal properties of the owner of the business to recover debts owed by the business)

Looking at the balance sheet, it is essential to understand that a business is funded partly by equity and partly by outside creditors of different kinds. When a venture is liquidated, all creditors must be paid off. Ideally, the venture's assets are sold, and the proceeds are used to pay the creditors. If the market value of the assets is insufficient to cover all debts, the personal properties of the owners may be sold to fill the gap. However, the personal assets of owners of limited liability companies are generally protected from such disposals. Their liability is limited to their investment in the venture. In contrast, in unlimited liability ventures such as proprietorships and partnerships, owners' assets like buildings and investments may be sold to cover the shortfall. Their liability extends beyond their investment.

Consider this scenario: you run a business and take out a loan from a bank. You also purchase materials from other businesses or individuals (collectively referred to as creditors). If, for any reason, your business fails to meet its payment obligations, the creditors can take legal action, obtain a court decree, and recover the money owed. The creditors have the option to sell the business's assets. Depending on the business's legal structure, they might also have the right to liquidate the personal properties of the owners.

In businesses with unlimited liabilities, such as proprietorships and partnerships, creditors can sell the owners' personal assets, such as buildings, land, and investments. However, in limited liability entities like One Person Companies (OPCs), Limited Liability Partnerships (LLPs), Private Limited, Public Limited, etc., creditors cannot liquidate the owners' personal assets to recover their dues. They can only recover funds by selling the business's assets.

Unlimited liabilities businesses may have the following forms:

i. Sole proprietorship – with only one owner
ii. Partnership – with multiple owners

In a proprietorship business, there's no distinction between the business and the proprietor. The business's profits are combined with the proprietor's personal income for calculating income tax. Such businesses have a limited lifespan since they cease to exist upon the proprietor's demise.

The same principle applies to partnership businesses, except that individual partners' incomes are not combined with the firm's income for tax assessment. The firm pays income tax based on its profits, independent of the partners' incomes. Each partner pays income tax based on their individual earnings.

It is easy to start a business with these types of legal forms.

You need a trade license, PAN number, and GST registration to start the business.

These types of firms cannot allot shares to investors of any kind to raise money.

a) Sole Proprietorship

- **Attributes**: A sole proprietorship is a business owned and managed by a single individual. It is the simplest and most common form of business in India, with no legal distinction between the owner and the business.
- **Advantages**:

  - Full control over business operations.
  - Easy and inexpensive to set up with minimal regulatory requirements.
  - Direct control over profits.
  - Simplified tax filing, as business income is treated as personal income.
- **Disadvantages**:
  - Unlimited liability: The owner is personally liable for all business debts and obligations.
  - Limited capacity to raise capital.
  - The business lacks continuity; it may cease to exist upon the owner's retirement or death.

b) Partnership

- **Attributes**: A partnership in India is formed by two or more individuals who agree to share profits, losses, and responsibilities. It can be registered under the Indian Partnership Act, 1932. Partnerships can be general or limited, with limited liability for some partners.
- **Advantages**:
  - Shared resources, knowledge, and skills.
  - Relatively easy to establish with fewer regulatory requirements than a company.
  - Greater ability to raise capital compared to a sole proprietorship.
- **Disadvantages**:
  - Unlimited liability for general partners.
  - Potential for disputes among partners.
  - Profits must be shared among partners.
  - Lack of continuity; the partnership may dissolve upon the exit or death of a partner.

Limited liability companies can take any of the following forms:

i. One Person Company (OPC) – only one director. Not permitted to allot shares to others.

ii. Limited Liabilities Partnership (LLP) – 2 to any number of partners

iii. Private Limited – 2 to 200 shareholders. Not allowed to allot shares to the public to raise money, but can allot shares to investors.

iv. Public Limited – No upper limit on number of shareholders. Can raise money from the public through Initial Public Offering (IPO) and list shares in stock exchanges.

Except for the OPC type of companies, all other types of businesses have perpetual life, meaning that the life of the companies is not dependent on the life of the owners. If any or all the owners pass away, the business remains a going concern, and new owners will take the reins of the company.

All limited liability companies must register with the Register of Companies (RoC), which takes some time and has to comply with certain statutory compliances such as obtaining the Director Identification Number (DIN), Digital signature, submission of audited financial statements, etc.

2. Limited Liability Forms of Business

a) Limited Liability Partnership (LLP)

- **Attributes**: An LLP, governed by the Limited Liability Partnership Act, 2008, combines the benefits of both partnerships and limited liability companies. Partners have limited liability for the business's debts.
- **Advantages**:
  - Limited liability: Partners are liable only to the extent of their contribution to the LLP.
  - Flexible structure with the ability to manage internally as per the agreement.
  - Lower compliance burden compared to a private limited company.
  - No limit on the number of partners.
- **Disadvantages**:
  - More complex and expensive to establish than a sole proprietorship or traditional partnership.
  - LLP cannot raise equity capital by issuing shares.
  - Certain regulatory requirements must still be met, including filing annual returns.

b) Private Limited Company (Pvt. Ltd.)

- **Attributes**: A Private Limited Company is a separate legal entity, distinct from its shareholders, and is governed by the Companies Act, 2013. It offers limited liability to its shareholders.
- **Advantages**:
  - Limited liability: Shareholders are liable only to the extent of their shareholding.
  - Easier to raise capital, including equity, from investors.
  - Perpetual succession: The company continues to exist even if ownership changes.
  - Ability to attract and retain talent through employee stock options (ESOPs).
- **Disadvantages**:
  - More complex and expensive to set up and operate.
  - Extensive regulatory compliance, including maintaining statutory records and filing annual returns.
  - Restrictions on the transfer of shares.

c) Public Limited Company

- **Attributes**: A Public Limited Company is a larger entity with the ability to raise funds from the public by issuing shares. It is governed by the Companies Act, 2013 and is subject to stricter regulatory oversight.
- **Advantages**:
  - Limited liability for shareholders.
  - Easier access to capital through public share offerings.
  - Increased credibility and public image.
  - Perpetual succession ensures the company's continuity regardless of ownership changes.
- **Disadvantages**:
  - Extensive regulatory compliance, including audits, disclosures, and maintaining transparency with shareholders.
  - Complex and costly to establish and maintain.
  - Founders may lose control over the business due to dispersed ownership.