UNIT 9 OWNERSHIP STRUCTURES AND ORGANISATIONAL FRAMEWORK

Structure

9.0 OBJECTIVES

After going through this Unit you should be able to:

- describe the different organisation alternatives open to you,
- distinguish between proprietorship, partnership and a company,
- explain the relative advantages and disadvantages of these legal forms, and
- outline the important considerations in the selection of an appropriate organisational form.

9.1 INTRODUCTION

In the earlier Units you have studied about environmental scanning, opportunity appraisal and preparation of the business plan for your enterprise. Integral to all these steps is the decision to choose upon the legal form of organisation within the framework of which you plan to carry out your activities. This Unit describes the various forms of business organisation, their comparative advantages and disadvantages, the tax structure associated with each form as well as the criterion that govern the choice of a particular form of business organisation.

9.2 FORMS OF BUSINESS ORGANISATION

As an entrepreneur, you wish to have a business of your own, but at the initial stage you are usually neither bothered nor keen to know what the legal and other aspects of the forms of a business enterprise are. But you can not postpone this decision for long because if you wish to raise a loan, your banker would like to know about the form of organisation your enterprise has. If you require a good team of employees, they might like to know about it and so on. So before you abruptly take a decision to opt for one or the other form of ownership of business, let us understand the various options. Your decision has to be the right one because every form has its inherent advantages and disadvantages, limitations, attendent risk and manner of operation. Further, your decision about choosing a specific form of ownership is guided by various factors such as your:

- personal capacity to take decisions, manage and control particular situations,

- capacity to cover risk,
- professional background which includes your educational background, technical expertise and experience or expertise in manufacture of proposed product, and
- capacity to invest in your dream enterprise.

Bhavna Verma before going in for her travel agency business was curious to know from her Chartered Accountant as to why a formal organisation is needed. Her Chartered Accountant satisfied her by telling that any activity done by an entrepreneur has a definite objective, which is a step towards his or her target, which in turn needs an organisation in one form or the other. Consequently, any business activity in order to be coordinated and managed needs to be organised in a formal pattern of relationship relating to ownership and control.

Further, at your desire you are free to change the form of ownership chosen. If you started your business as sole proprietorship, you may convert it to partnership or to a company, or vice-versa, whenever you want. Your options are confined to the following forms of ownership:

i) Individual Proprietorship

ii) Partnership-Joint family business

iii) Partnership with others

iv) Private limited company

v) Public limited company

vi) Co-operative society.

9.3 PROPRIETORSHIP

You are master of your show. In a proprietorship the enterprise is owned and controlled only by one person. Here a single person sows, reaps and harvests the output of his or her labour. Of course there are relatives, friends, family, financial institutions, Government and employees to assist him or her. This form is one of the most popular forms in India and the reason for its being so popular is, the advantages it offers.

Ms Rekha preferred a sole proprietorship because her business was going to be very small and the degree of risk involved, not very high. Ravi Bhushan preferred this form of ownership for his business because it does not require legal recognition and attendent formalities. In this form of ownership, business can be started simply after obtaining necessary manufacturing license and permits. Most of the small enterprises in tourism sector are sole proprietorship business.

9.4 PARTNERSHIP

When the quantum of business is expected to be moderate and the entrepreneur desires that the risk involved in the operation be shared, he or she may prefer a partnership. Swatantra Rastogi and Shashi, when they started a business of car rentals preferred a partnership because one of them had experience in this area and the other had money. In India the law relating to the partnerships is given in the **Indian Partnership Act, 1930**. A partnership comes into existence when two or more persons agree to share the profits of a business, which they run together. This business may be carried on by all or by any of them acting for all. Those who, thus, enter into an agreement are individually called as ‘partners’ and collectively they are called as ‘firm’. The name under which their business is carried on is called the ‘Firm name'. Some say that firm is nothing but an abbreviation for partners. The characteristics of a partnership are:

i) Partnership is the outcome of **a voluntary agreement** between the persons, who after the agreement has been arrived at, would be known as partners. Therefore, a partnership cannot come into existence by a law or by status and a partnership agreement should have all the essentials of a valid contract.

ii) A relation of partnership can be entered into between persons only. Maximum number of members that a firm may have is twenty but if the agreement is to carry on banking activities, not more than ten persons can be a partner in such a firm. A partnership becomes illegal if it includes more than stipulated number of persons.

Although it is left to the choice of the partners to decide as to what should be mentioned in their partnership agreement but usually following matters are spelled out in the agreement:

1) The object and duration of partnership,
2) The duties of partners,
3) The rights of partners,
4) How the losses and profits of the business shall be divided,
5) Procedure to be followed when any partner wishes to withdraw from the partnership or a new partner enters the business, and
6) Manner in which any controversies that arise out of the partnership agreement will be settled.

In order to appreciate a partnership we should distinguish it from certain non-contractual, quasi-partnership relationships, which may be created on account of specific customs of person law. The members of a Hindu undivided family carrying on a family business as such, or a Budhist husband and wife carrying on business as such, are not partners in such business. These relationships do not come into existence owing to a voluntary agreement amongst them and are therefore not partnership but ''joint ownership''. The contract by which the partnership is created may be express or implied. It is express when it is in writing or is created by words of mouth; it is implied when it is to be inferred from the conduct of the parties or from the circumstances of the case. **But in view of the disadvantages suffered by an unregistered firm it is in your interest that the partnership agreement should be drawn in the beginning and signed by all of you, who have agreed to enter into a partnership**. It is advisable even when you are intending to commence the relationship with your wife or vice versa. The losses are a fact of business life. The partners are free to provide in their partnership agreement that one or more than one of them will not be responsible to the losses of the business.

iii) Another characteristic of a partnership is sharing of profits of business amongst the partners. Unless specifically mentioned, all partners are supposed to share the profits and losses of the business in equal share. Sharing of profits is a hallmark of a partnership but everyone who takes share in profit does not thereby becomes a partner. The receipt of such share or payment, by a lender of money to persons engaged or about to engage in any business or by a servant or agent as remuneration or by the widow (or child) of a deceased partner as annuity or by a previous owner or past owner of the business, as consideration for the sale of the goodwill or share thereof, does not on itself make the receiver a partner of the persons carrying on the business.

iv) The business of partnership may be carried on by all the partners or it may be carried on by any one of them acting for all. This element of partnership, mutual agency, shows that the persons of the group who manage the business do so as agents for all the persons in the group and are bound by their acts and liable to account for all.

After knowing the essential characteristics of partnership let us remember that a partnership may be created for a fixed period only or even for execution of a particular venture. It is a fundamental feature of partnership that every partner has an option to withdraw from the partnership at anytime, after complying with the formalities stipulated in the Act and in the partnership agreement.

A natural query at this stage may be: Can a minor become a partner? The answer is no, but with the consent of all the partners, the minor may be admitted to the partnership to share the profits of the business, carried on by them. Such a minor has the right to such share of the property and of such profits of the firm as may be agreed upon, the point to remember is that the minor is not personally liable for the losses of the business, only his or her share in the partnership business is liable for the acts of the firm. When such minor attains maturity or when he or she obtains knowledge that while he or she was a minor and was admitted to the benefits of partnership, which ever date is earlier, within six months of such date, such person is required to decide whether he or she selects to become or not to become a partner, in the firm. Such selection shall determine his or her position as regards the firm. If he or she decides to become a partner his or her rights and liabilities continue from the date on which one becomes a partner and one also becomes personally liable to third parties for all acts of the firm done since he or she was admitted to the benefits of partnership.

If he or she decides not to become a partner in that situation his or her rights and liabilities shall continue to be those of a minor upto the date on which he or she gives public notice of one's intention of not continuing his or her relationship with the firm.

Duties of Partners

Partners are free, of course, subject to the provisions of the Partnership Act, to agree upon their mutual rights and duties. This agreement is not immutable and the terms of the agreement may be varied by consent of all the partners. Usually the partners agree to the following duties that:

1) any partner shall not carry on any business other than that of the firm while he or she is a partner,
2) the partner will attend to his or her duties diligently in the conduct of the business,
3) he or she shall indemnity the firm for any loss caused to it by his or her fraud or willful neglect in the conduct of the business,
4) he or she shall not derive any profit for himself or herself from any transaction of the firm or from the use of the property or business connection of the firm or the firm name,
5) he or she will be liable jointly with all other partners and also individually for all the acts of the firm done while he or she is a partner, and
6) he or she will remain just and faithful to other partners and will render true accounts and full information of all things affecting the firm to any partner or his or her legal representative.

Rights of Partners

As the partners are free to decide their duties, they are likewise free to decide by contract between themselves their mutual rights. Usually, a partnership agreement guarantees the following rights to every partner that:

1) every partner is entitled to take part in the conduct of the business,
2) every partner has a right to have access to and to inspect and copy or any of the books of the firm,

3) every partner is entitled to share in the profits earned,

4) every partner has a right to be indemnified in respect of payments made and liabilities incurred by him or her in the ordinary and proper conduct of the business,

5) every partner has a right to be consulted and heard before any decision is taken in relation to any matter concerning the firm, and

6) if any partner makes for the purposes of the business any payment or advance beyond the amount of capital he or she has agreed to subscribe, is entitled to interest thereon.

Registration of Firms

The law relating to registration of firms is very interesting. While it is not compulsory for a firm to get itself registered but it becomes highly desirable for firms to get themselves registered because of the limitations an unregistered firm has to face.

For the purposes of registration the State Government appoints a Registrar. When you want to get your firm registered you may send your application to the Registrar of Firms along with prescribed fee. This application may be sent by post or may be delivered in person to the Registrar of the Area in which the place of the business of the firm is situated or proposed to be situated.

The application has to be in the form of a statement which should indicate the :

a) first name,

b) place or principal place of business of the firm,

c) names of any other place where the firm carries on business,

d) date when each partner joined the firm,

e) names in full and permanent addresses of the partners, and

f) duration of the firm.

This statement should then be signed either by the partners or by their agents specially authorised in this behalf. After affixing their signatures, these signatures have got to be verified. When the Registrar is satisfied that all formalities relating to registration have been properly complied with, he shall make suitable entries in a register known as Register of Firms and shall issue a certificate of registration.

In order to fully appreciate this part, you should know the effect of non-registration of a firm. If a firm is not registered:

1) No suit to enforce a right arising from a contract or conferred by this Act shall be instituted in any court or on behalf of any person such as a partner. Such a suit can neither be instituted against the firm nor against any co-partner including a past co-partner.

2) No suit to enforce a right arising from a contract can be instituted by or on behalf of a firm against any third party.

3) Neither the firm nor any partner is competent to make a claim or other proceedings based upon a contract. However, this disability does not restrain the third parties to sue the firm or any partner for the enforcement of their rights.

Dissolution of firm

If one or more than one partners leaves the firm and other partners continue the firm, it is called **dissolution of partnership** but when all and each one of the partners ceases to carry on the business and decide to separate, it is **dissolution of the firm**. Strictly speaking, the dissolution of partnership between all the partners of a firm is called the "dissolution of the firm". A firm may be dissolved with the intervention of the court or without the intervention of the court. Following are the ways in which a firm may be dissolved:

i) With the consent of all the partners or in accordance with a contract between the partners; since a partnership is created by a contract, it can be dissolved by a contract. At anytime during the firm's life, all partners may decide to dissolve it or may dissolve it in accordance with a contract already made in the partnership agreement. For example, Mohit Kumar and Ajay Kumar are partners in a firm. The partnership deed provides that the firm can be dissolved only by mutual agreement. Mohit Kumar wants to dissolve the firm. He cannot compel Ajay Kumar to dissolve the partnership.

   The situation would be different if the partnership is 'Partnership at will'. In such a case the firm may be dissolved by any partner giving notice in writing to all the other partners. The firm in such a case shall stand dissolved from the date of notice. If no date is given in the notice the dissolution will be effective from the date of the communication of the notice.

ii) **Company dissolution**

   Under any of the following circumstances a firm is dissolved:

   a) by the adjudication of all or of all the partners but one as insolvent, or

   b) by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership.

   M/s. Rainbow Financiers which has twelve partners, is carrying on business of financing automobiles. The Parliament passes an Act which makes it unlawful for any firm having more than ten partners, to carry such business. The partnership is dissolved.

   However, if the firm carries on separate undertakings or adventures, the illegality of one or more shall not on itself cause the dissolution of the firm in respect of its lawful adventures and undertakings.

iii) **Dissolution on the happening of certain contingencies**

   If the partners so agree a firm is dissolved:

   a) if constituted for a fixed term, by the expiry of that term,

   b) if constituted to carry out one or more adventures or undertakings, by completion thereof,

   c) by the death of a partner, and

   d) by the adjudication of a partner as insolvent.

iv) **Dissolution by Court**

   Under any of the following circumstances any partner may present a petition before the court for the dissolution of the firm, whereupon the court may dissolve the firm, when:

   a) any partner has became of unsound mind,

   b) any other partner has became in any way permanently incapable of performing his or duties as partner,

   c) any other partner is guilty of conduct which is likely to affect prejudicially the carrying on of the business, regard being had to the nature of the business,

   d) any other partner willfully or persistently commits breach of agreement relating to the management of the affairs of the firm or the conduct of its business, or otherwise so conducts himself or herself in matters relating to the business that it is not reasonably practicable for the other partners to carry on the business in partnership with him or her,

e) any other partner has transferred the whole of his or her interest in the firm to a third party, or has allowed his or her share to be attached or to be sold in the recovery of arrears of land-revenue or of any dues recoverable as arrears of land-revenue due by the partner,

f) the business of the firm cannot be carried on save at a loss, or

g) there exists any other reasonable ground which renders it just and equitable that the firm should be dissolved.

Check Your Progress–1

1) Why you have to choose the form of your organisation?

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2) Discuss the characteristics of partnership.

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9.5 COMPANY

Besides partnership, which is a very common form of organisation among small entrepreneurs, another form of ownership that you should know about is a Company. The law relating to companies in India is contained in the Companies Act of 1956.

Let us know what a Company is? A Company may be understood as an association of persons in which money is contributed by them, to carry on some business or undertaking. Persons who contribute the money are called the shareholders or the members of the company. Given below are the characteristics of a company:

a) **Artificial legal person**: As soon as an association of people gets incorporated as a company, it assumes the identity of an artificial person. Since the company after incorporation in the eyes of law is treated as person, the company may sue or be sued by its members/shareholders whenever any breach of their rights or duties is committed. As a person the company can enter into contracts in its own name and likewise may sue and be sued in its own name.

b) **Separate legal entity**: As is apparent from the above description after registration the company acquires a personality of its own which is distinct and different from the personality of the members/shareholders constituting the company. Although an independent person yet the company can neither think, nor do anything by itself, therefore, its affairs are managed by a Board of Directors, who manage the affairs of the company on behalf of the company and in accordance with its Memorandum and Articles of Association.

c) **Common seal**: A company, being a natural person acts through natural persons (directors and other authorised managerial personnels of the company). Hence, when any contract is entered in the name of the company, the company's seal is required to be put on the same in order to make the contract binding on the company.

d) **Perpetual existence**: The company being a creation of law is not effected by the joining, leaving, death, insolvency or insanity of any of its shareholders. Since the company enjoys a separate legal existence from that of its members, any variation in the number or identity of its members does not affect the corporate existence and corporate identity. It is rightly said "members may come, members may go but the company goes for ever". Further since a company comes into existence only through a process of law, it can only be dissolved through a process prescribed by law.

e) **Transferability of shares**: The shares of a Joint Stock company (except private company) are freely transferable. A private company through its articles places certain restrictions on the transferability of its shares. For all other joint stock companies members owing fully paid up shares can freely transfer their shares at a stock exchange or through agreements entirely on their own discretion but subject to the rules of the company. Any absolute restriction on the transfer of shares of the company is, however, avoided.

f) **Limited liability of members**: This characteristic emerges as one of the major advantages of this form of organisation. In case of a company limited by share, the liability of the members of the company is limited to the nominal value of shares held by them. In case of a company limited by guarantee, members are liable only to the extent of the amount guaranteed by them.

An incorporated company is a corporate body and by action of law it is treated as a legal person. This means that a company has a personality of its own. The company thus has an independent status which is different form the status of the members/shareholders constituting it. Consider this example: Ajay Kumar, Arun Kumar, Mohit Kumar and Sadhna form a company and get it registered in the name of Mitter Kumar Pvt. Ltd. Once the company is registered this company Mitter Kumar Private Limited will be regarded as a person and as such would have an independent personality different from the personality of Ajay Kumar, Arun Kumar, Mohit Kumar and Sadhna.

Depending upon the type of restrictions you want to impose upon your organisation, you may form a:

- Private Company, or a
- Public Company.

Under Section 3(i) (ii) of the Companies Act, a Private company has been defined as a company which by its Articles of Association:

a) restricts the right to transfer the shares, if any,

b) limits the number of its members to fifty, and

c) prohibits any invitation to the public to subscribe for the shares or the debentures of the company.

A public company by definition Sec. 3(i) (iv) is a company which is not a private company. By implication, therefore, public company is one, registered under the Companies Act which places no restriction by its Articles of Association on the transfer of shares or on the maximum number of members/shareholders and can invite the public to subscribe for its shares debentures and public deposits. You must understand that these provisions also mean that any member of the public who is willing to pay the price may acquire shares and debentures of your company. This has interesting implications for dilution of ownership and control which you may like to consider before deciding upon the organisational form. The distinctions between a private company and a public company have been detailed out in **Table 1** below:

Table-1

			Public Company		Private Company
1)	Formation	a)	At least Seven members are required.	a)	At least two members are required.
		b)	Formation is difficult because it requires many formalities such as consent of the directors, copy of contract to acquire qualification share within stipulated time, has to be filled with the registrar of Companies. Before such company can commence business it should obtain Certificate of Incorporation as Certificate of Commencement of business.	b)	Formation is simpler. Documents relating to directors' acquiring qualification share are not required to be submitted to the registrar of Companies, nor director's consent to act as director is needed. Such company can commence its business soon after obtaining Certificate of Incorporation.
		c)	Minimum number of directors needed is three.	c)	Minimum number of directors needed is two.
		d)	Minimum number of members needed is seven.	d)	Minimum number of members needed is two.
		e)	No restriction on the maximum number of members.	e)	Maximum number of members cannot exceed fifty.
2)	Prospectus	a)	Filing of prospectus or a statement in lieu of prospectus with the Registrar of Companies is necessary before company can allot shares.	a)	Not needed.
3)	Documents	a)	Seven members have to sign the memorandum and articles of association.	a)	Only two members need to sign the documents.
		b)	Need not prepare articles if it chooses to adopt table A of the Companies Act as its articles of association.	b)	Articles of association have to be compulsorily framed as the company places certain restriction on itself through the provisions of its articles.
4)	Allotment of shares	a)	Shares cannot be allotted till the amount of maximum subscription in cash has been received.	a)	No such restriction is applicable.
		b)	Can issue only equity and preference shares.	b)	Can issue both equity and preference shares as well as share with disproportionate voting rights.
		c)	Invitation to public to subscribe for the shares, debentures or public deposits can be made through prospectus.	c)	No such public invitation can be made.
5)	Transfer of shares	a)	Shares are freely transferable and can be quoted on the Stock Exchange.	a)	Transfer of shares restricted by the articles therefore shares cannot be quoted at the Stock Exchange.
		b)	Company can issue bearer share warrant.	b)	Such warrant cannot be issued.

6) Directors	a) Law places restrictions on the remuneration payable to directors,	a) No such restrictions applies.
	b) Directors are subject to retirement by rotation.	b) Directors are not liable to retire by rotation.
	c) Loans to directors cannot be sanctioned without approval of the Central Government.	c) Directors can borrow from their company without the approval of the Central Government.
	d) Any director having any interest in any subject matter of the meeting cannot participate and vote on the issue.	d) Interested directors can participate as well as vote.
7) Statutory meeting	a) Company must hold a statutory meeting and file a statutory report with the Registrar of Companies within six months from the date of obtaining the Certificate of Commencement of business.	a) No such restriction applies.

In view of the restrictions discussed in relation to the private company you may think that it may not be a very preferred form of ownership. On the contrary, a substantial number of entrepreneurs prefer to form a private company, as the private company has been granted several privileges under the Companies Act. Some important privileges among those are:

i) For forming a private company only two members are required.

ii) Such company may commence business immediately after incorporation.

iii) A private company is not required to hold a statutory meeting nor is it required to file a statutory report.

iv) Such company may issue any kinds of shares and allow disproportionate voting rights.

v) A private company need not file a prospectus or a statement in lieu of prospectus, to the Registrar of Company.

vi) The directors of a private company are not required to file their consent to act or to take up their qualification shares prior to their appointment.

vii) The directors of a private company are entitled to vote on a contract in which they are interested.

viii) A non-member can not inspect the copies of profit and loss account filed with the Registrar of Company.

ix) Limits imposed by Section 309 of the Act, on payment of maximum managerial remunerations are not applicable.

In case of both private and public companies, on the basis of liability of members, companies can be classified as:

a) Company limited by share,

b) Company limited by guarantee, and

c) Unlimited company.

Company limited by share is a registered company in which the liability of members is limited to the amount remaining unpaid on the shares held by them.

Company limited by guarantee means a company in which each member is liable, in the event of liquidation, to pay a specified sum of money, guaranteed by him or her. If the guarantee company has share capital also, the members have two fold liability, to pay the amount which remains unpaid on their shares, whenever called upon to pay and secondly to pay the amount payable under the guarantee when the company goes into liquidation. The voting power in a guarantee company is determined by the shareholding and not by the guarantee. An unlimited company (Section 12(2-C) is a company not having any limit on the liability of its members. In the event of the winding up of the company, the liability of the members may reach upto the limits of their personal assets, to meet the obligations of the company. Such companies may or may not have share capital. It may interest you to know that the company law recognises some more classes of companies, important among them are:

a) Government company,

b) Foreign company, and

c) Holding and subsidiary company.

A Government company is one in which "not less than 51%" of the paid up share capital is held by the Central Government or by any State Government or Governments or partly by Central Government and partly by one or more State Governments. Indian Telephone Industry, Hindustan Machine Tools, and Hindustan Aeronautics Limited are examples of a Government company.

A foreign company is a company which is incorporated in a country outside India under the law of that country but has established a place of business in India. Some of the provisions of the Indian Companies Act are applicable to such companies. A foreign company may be either a private company or a public company.

A holding company is one which has another company as its subsidiary. According to section 4 of the Companies Act, a company shall be deemed to be subsidiary of company B if and only if

i) Company B (holding company) controls the composition of the Board of Directors of Company A (subsidiary) or

ii) Company B (holding company) controls more than 90% voting powers of company A (subsidiary) or

iii) if Company A is a subsidiary of Company C which is itself the subsidiary of the company B.

Formation of a Company

As you must have earlier noted a company comes into existence only after registration. For registration the following documents need to be filed with the Registrar of the companies of the State in which the company wants to have its registered office.

i) **Memorandum of Association**: It is a document originally created for every company which governs the area of operation and the relations of the company with the third parties. It mentions the name of the company, place of its registered office, object/objects of the company and lays down provisions regarding its capital and the liability of its members, shareholders and lastly a declaration by the members of the company and they have associated to form a company and that are the necessary formalities have been complied with.

ii) **Articles of Association**: It is another document consisting of regulations for all aspects of the internal management of the affairs of the company like the rights of members, conduct of meeting, appointment and removal of directors, etc.

iii) A list of persons who have given their consent to be the first directors of the company (Applicable in case only of a public company).

iv) A written undertaking by each of the proposed director to accept and pay for their qualification shares, if any (Applicable only in case of a public company).

v) A statutory declaration, by a Chartered Accountant as director of Company or an Advocate or the Secretary or a person who is named along with the required registration fee and the stamp duty, declaring that all the legal requirements of the Companies Act in respect of formation of the company have been complied with. As the company has not yet come into existence, the preparation of these documents and fulfilment of the attendent formalities are undertaken by a group of individuals, an individual interested in the formation of the company called the promoter of the company.

After being satisfied that all the documents are in order and all the formalities relating to registration of a company have been complied with, the Registrar of Companies would register the company and would issue a certificate of Registration of the Company. A private company can commence its business after obtaining this certificate. But a public company cannot commence its business unless it has obtained yet another certificate from the registrar of Companies – Certificate of Commencement of Business.

Management of the Company

You have already noted that a company is managed by the system of representative management, i.e., through the medium of individuals known as directors, collectively known as the Board of Directors or the Board. The directors act as the brain of the Joint Stock Company. Legally their position is that of an agent of the company in some aspects and that of a trustee in some other aspects. As trustees, in respect of the properties and powers of the company, the directors, are expected to act in good faith and in the interest of the company as the company with outsiders and are liable in all cases where an agent is personally liable under the law of contract. Although in matters relating to the management of the company the directors are the highest authority, legal restrictions on their powers have been put through the Memorandum and Articles of Association, the Companies Act and the general law of the land.

Winding up and Dissolution of the Company

Being a creation of law a company can be wound up only through a process prescribed by law. Winding up is the process by which the assets of the company are realised and used for the subsidiary of company B then company A is a subsidiary of company B. A company can be wound up by the following modes:

1) Winding up by court,
2) Voluntary winding up,
   - Member's voluntary winding up,
   - Creditor's voluntary winding up
3) Winding up under the supervision of the court.

You must be clear about the fact that even if all the members of the company or all the creditors or both agree to dissolve the company, even they cannot do so except through a process of law as a company like partnership has not come into existence through a contract between members but through a process of law.

9.6 FORMS OF OWNERSHIP — ADVANTAGES AND DISADVANTAGES

Having understood the salient characteristics of different forms of business organisation, let us now assess the relative advantages and disadvantages of these forms.

The Proprietorship

A sole proprietorship, as you know, is a business owned and controlled by one person and being the simplest form of a business enterprise it has several advantages such as:

1) Lack of restrictions,
2) Owner's enjoyment of all profits,
3) Owner's freedom to take all decisions,
4) Financial advantages,

5) Tax advantages, and

6) Secrecy.

1) **Lack of restrictions**

Lack of restrictions or minimum legal restrictions is the distinguishing feature of a proprietorship concern. In a proprietorship the entrepreneur is required to file few reports and is not required to draw up legal documents to commence his or her business nor is he or she required to pay any fees to set up his or her business. No formal registration is statutorily needed. Most common amongst the proprietorships are the sole proprietorships, i.e., one person operating the whole business.

2) **Owner's enjoyment of all profits**

One advantage of proprietorship is that the owner keeps to himself or herself all profits of his or her labour. Unlike other forms of ownership, in a proprietorship, there is no other person to share his or her profits, which in turn is a source of great personal satisfaction to him or her.

3) **Owner's freedom to take all decisions**

Another advantage of proprietorship is that the proprietor is free to make all decisions. There is no other person who can weigh him down or create administrative problems for him or her. In this way he or she may freely concentrate on the business.

Ravi Khatoo owns a nursery which employs 19 people. The nursery has been operating quite successfully during the entire period. Number of customers has increased by an average of 30 per cent per year. One factor behind his sale strategy is that he makes a discrete option in offering the plants at a particular price and is not bothered about the profits. His prime object is the future business which he thinks he is likely to get from a particular person. This freedom of decision has paid good results to him.

4) **Financial advantages**

One major advantage of a proprietorship is the financial advantage involved in this form of ownership. Personal reputation and personal assets stand behind the concern. Whenever needed the proprietor can draw upon both to augment his or her business resources.

5) **Tax advantages**

A proprietorship form of legal organisation has certain tax advantages which are not available to the other forms of business ownerships. Individual proprietorship income is taxed only once while corporate income is at occasions, taxed twice. Tax action with respect to all the forms of organisations is discussed separately.

6) **Secrecy**

Secrecy is another major advantage offered by proprietorship. In present day business atmosphere, the less a competitor knows about one's business, the better off one is. In proprietorship the proprietor is required to reveal very few things to others, about his or her operations, he or she can keep business secrets to oneself and the competitor can only guess estimates regarding its sales, profit margins and overall financial strength.

Disadvantages of Proprietorship

In spite of all the above mentioned advantages, there are some drawbacks associated with the proprietorship. In deciding whether the type of operation will suit him or her best for the business, the entrepreneur needs to consider such things as:

1) **Owner's probable lack of ability and experience**: The owner may truly lack requisite ability and experience to run a business enterprise on one's own. Though this flaw in the entrepreneur's capability does not apply in sole proprietorship only, it could apply as well in partnership and companies. In the latter cases the lack of ability and experience may be compensated by the ability

and experience of other partner/directors. In sole proprietorship since the entire decision-making is centralised in owner's hands this flaw may become a debilitating one.

2) **Difficulty in raising capital**: The raising of capital single handed can be a problem as the owner has only his or her own assets and goodwill to fall back upon, abetted by the assistance provided by the financial institutions. As a generalisation one person would have less to invest to meet the capital needs of a new small business then a group of owners. If the owner does not wish to share the ownership of the business, the alternatives for raising capital for the business are rather limited.

3) **Limited life of the organisation**: The life of the proprietorship depends solely on the proprietor. If he or she dies, becomes insolvent or permanently incapacitated or insane, the business may wind up. This has implications not only for the employees of the organisation but also for the creditors. It is this implication which finds an expression in the restrictions on credit granted to the sole proprietor. It is not uncommon to find creditors requiring the proprietor to carry life insurance sufficient to meet the financial obligations of the proprietorship.

4) **Limited size**: There being only one owner of the business the amount of capital that can be raised for operations and consequently the probability of attaining a large size are limited. This is especially true since the growth of a proprietorship is to a large degree dependent upon reinvested profits. As the capital that can be raised is limited the growth of the business can also attain only a limited size. The problem of size may also have managerial ramifications. Being the only owner the proprietor is responsible for carrying out all decision-making activities and quite a few of the operational ones. This can become a burden as the business increases in size. Delegation of authority offers a solution, but the major decisions continue to be the owner's responsibility. It is then that he or she makes a conscious decision on whether or not to increase the size of the business enterprise any further.

5) **Unlimited liability**: By far as the greatest disadvantage of sole proprietorship is that of unlimited liability. The sole proprietor is personally responsible for all the debts that he or she incurs. The creditors having a claim on these debts can exercise it against both the business and the personal assets of the proprietor. For example if the proprietorship operation is worth Rupees 10 lakhs but the proprietor has debts of 25 lakhs, the creditors can sue the proprietor and force him or her to liquidate personal assets to pay the financial obligations. What this amounts to is that even though the proprietor believes that only part of his or her total capital is invested in the business, one is liable to the full extent of total personal assets for liabilities of the business. A damaging law suit lost, a serious accident involving injuries to employees, a critical marketing setback are some of the contingencies that can create liabilities for beyond investments and all other assets become liable and may be endangered.

Advantages of Partnership

From the point of view of evaluating it as an organisational form the following advantages of partnership must be considered:

a) **Ease of organisation**: As partnership is based on mutual contract between all the partners, it is relatively ease to form. The legal formalities associated with formation are minimal, so much so that registration of a partnership firm though desirable, is not obligatory.

b) **Combined talent, judgement and skill**: The old maxim of two heads being better than one aptly applies to partnership. If these are three or four or more partners the chances that better decisions collectively will emerge are higher than in case of a proprietor operating alone. Pooling of skills, especially when each partner specialises in a different area gives the firm a competitive advantage of collective expertise.

c) **Increased sources of capital and credit**: We have just seen that the sole proprietorship suffers from the limitation of limited capital because there is only one individual to invest his or her assets and bring in credit. A partnership can overcome this problem to a certain extent by bringing into association more people with capital to invest as well as personal assets that can be used as collateral for bank loans and other credit. The lending institutions also perceive less risk in granting credit to a partnership than to a proprietorship because the risk of loss is spread over a number of people rather than only one.

d) **Improved chances of growth**: Consequent upon the increased sources of capital and credit and better decision-making potential, the partnership is in a much better position to expand and grow than a proprietorship. Being managed by a group of people, a partnership has both monetary and managerial resources to manage larger facilities and more employees. Therefore, as the operations expand in size, the owners are able to maintain effective control.

e) **Tax advantage**: From the taxation point of view partnership seems to be the most desirable form of organisation as the taxation rates applicable are lower than both the other forms in question. You will get a fuller exposure to taxation provisions relevant to these forms of organisations in a later section of this Unit.

Disadvantages of Partnership

In spite of its numerous advantages the partnership also has some important disadvantages which must be seriously considered before opting for this form of organisation:

1) **Unlimited liability**: As already noted, unlimited liability is an important characteristic of partnership. Just as this condition is applicable to proprietorship, it becomes an even more serious limitation in partnership. Not only is a partner liable to the extent of one's personal assets, for the debts of the firm, but he is also responsible to the full extent of one's resources for the debts contraded by other partners. Similarly, as profits and losses are to be shared between the partners even if one partner cannot come up with his or her share of the losses, the others will have to make up the deficits.

2) **Limited life**: If any partner dies, becomes insane or is otherwise incapacitated or simply wants to withdraw from the business, the partnership gets terminated. As the number of partners increases, the probability of occurrence of these contingencies goes higher. This creates problems of continuity in business.

3) **Divided authority**: We just talked about the maxim of two heads being better than one, carried to an extreme the situation may turn into "too many cooks spoil the broth". As long as each partner restricts his or her activities to one's defined area of operation, the problems of divided authority can be checked. However, other areas like policy formulation for the whole firm, financing plans, evolving personnel policy and ideas on expansion can create possibilities for conflicting authority.

4) **Danger of personal disagreements**: Being an association of people, a partnership is always open to the danger of disagreement between its members which at times may become extremely serious. Even if a partnership agreement is thoroughly detailed, clauses may be subject to different interpretations. Some partners may wilfully exceed their defined authority and discontent may develop because of diverse working styles and conflicting egos. Many successful partnership firms have been dissolved because of serious disagreement between the partners.

Advantages of a Company

The important among the advantages of a company are:

a) **Limited liability**: The advantage of limited liability offered by a company forms an effective incentive for choosing this form of organisation as the shareholders are fully aware that they stand to lose no more than what they have agreed to invest in the business.

b) **Perpetual existence**: Continuity to the business is ensured as unlike a partnership or a proprietorship, a company enjoys perpetual succession. Death, incapacity or insanity of the shareholders do not affect the corporate existence of the company as the shares simply get transferred to the legal heirs who can sell them further if they do not want to retain the share contingencies like insolvency of the shareholder or selling of the shares by him or her also do not bring the life of the company to an end. As these factors would only result in the change of ownership of shares.

c) **Transferability of shares**: Ease of transfer of interest in a company represents another major advantage of companies. The very fact that you can transfer your interest anytime you want to, facilitates both investment and disinvestment decisions in this form of organisation.

d) **Expansion potential**: In comparison to proprietorship and partnership, the company has far greater potential for raising capital through issue or shares. This has implications for both ease and volume of expansion.

e) **Representative management**: Both proprietorship and partnership are characterised by direct management in that the owner/partner directly participate in the management of the organisation. A company on the other hand is characterised by representative management in that shareholders elect the directors to manage the company. The directors in turn manage the company as agents and trustees of the company, for the benefit of the company. If found to be deficient in performing their duties, any director may be removed. In addition to the Board of Directors, the company also relies on bringing in specialists as managers to manage the affairs of the company, which augurs well for efficiency and management.

Disadvantages of a Company

a) **Lack of secrecy**: As the company has to make various statements available to the Registrar of Companies and Financial Institutions, there is much less confidentiality of operations as compared to the other forms of organisations. In addition, the company has to provide an annual report to every shareholder, which further reduces the degree of secrecy, as everyone including the competitors can find out details of all financial data.

b) **Legalities of formation**: Being a creation of law, a company involves far more legal formalities of formation in comparison to the other two forms. These includes registration and pre-registration formalities like preparation of documents entering into pre-incorporation contracts, obtaining the consent of directors and furnishing the stamp duty. All these steps considerably lessen the ease of formation characterising the other forms of organisation.

c) **Legal restrictions**: The operations of a company are far more regulated by the comprehensive legislation of the Companies Act. Almost all aspects of its management and operation must comply with the provisions of the Act. In addition to the Company Act, several other Acts impose restrictions on the activities of companies in India.

d) **Heavy taxation**: Companies are subject to heavier taxation rates. There is also an incidence of double taxation in that after deducting tax, when the company pays dividend to its shareholders, the individual shareholders is also liable to pay personal income tax on all dividends recovered depending upon their respective tax brackets.

9.7 TAXATION AND THE LEGAL FORMS OF ORGANISATION

The different forms of organisation are subject to different tax rates under the provisions of the Indian Income Tax Act 1961. Even though these provisions keep changing, it will be useful for you to have an overview of tax structure for different forms. The following Section gives a brief explanation of tax structure applicable to sole proprietorship, partnership and companies.

i) **Sole proprietorship**

Under the sole proprietory form of organisation, it is not the business but the proprietor who is put to tax and it is not only the business income/loss but the total income from all the sources accruing to the proprietorship which is taxed together as one bloc. Certain incomes can accrue only to an individual such as salary. Apart from being single taxation the proprietor can set off any business losses from his or her other incomes and enjoy tax immunity to that extent. The proprietor may also get tax relief for institutionalised savings and investments. By institutionalised savings we mean investments made in paying the LIC premium, Provident Fund/Public Provident Fund contribution etc., money spent in purchase of National Savings Certificates or paying installments for acquiring a residential house from any public housing agency or investment in new shares etc.

As against this the major disadvantage of this form of business is disallowance of any personal expense incurred for the benefit of proprietory.

ii) **Partnership**

Firm is one of the most popular assessable entities under the Income Tax Act, providing perhaps the best and the least questioned tax planning device. The Income Tax Act has adopted the same definition as given by the Indian Partnership Act, 1932, which defines 'Partnership' as a relation between persons who have agreed to share the profits of a business carried by all or any of them acting for all.

Under the Partnership Act, a 'Partnership' or 'firm' is nothing but a group of persons (as such is not a separate independent entity or person in law) and has no legal personality apart from the partners, whereas under the Income Tax Act, the firm is a separate and distinct legal entity chargeable to income-tax and, therefore, is a taxable unit. Therefore, the provisions of the Partnership Act in this regard cannot be applied to the Income Tax Act. A firm is not entitled for various incentives provided under the Income Tax Act for Savings. Expenses and Incomes and certain payments made to partners are disallowed in computation of firm's income.

iii) **Classification of firms**

For the purpose of Income-tax, firms have been classified as registered and unregistered firms. 'Registered Firm' means a firm which has been registered under the provisions of Income Tax Act. In the case of registered firm, after assessing the total income of the firm, the income tax payable of the firm itself is determined. Thereafter the share of each partner in the income of the firm less proportionate tax is included in his total income and assessed to tax accordingly.

Therefore, it can be said that income of a registered firm is subject to double taxation, (Income of a registered firm is taxable) first in the hands of the firm and thereafter the same income is taxable in the hands of partners. Whereas, on the other hand, an unregistered firm pays tax as its income like an individual and share in profits is included in the individual assessment of partners for the limited purpose of calculation of rate of tax. In other words, share of profits from an unregistered firm is not taxed again and included in the personal income of partners for rate purpose only.

Another classification of firms is firms carrying on profession and firms carrying on business. Section 64(1)(i) is applicable to the firms carrying on business and not to those carrying on profession. However, both 'profession' and 'business' carry a wider meaning for tax purpose than generally understood. The tax rates for firms carrying on profession is a little lower than for other firms.

As mentioned earlier an unregistered firm is liable to pay tax applicable to an individual, whereas a registered firm is taxable at concessional rates.

The maximum and minimum rate in the case of an unregistered firm for assessment every year keep changing and one must update oneself on these rates. Utilising the services of a tax consultant or a chartered account is helpful in this regard. The same is the case in relation to a registered, professional or any other firm. The rates vary in each case.

iv) **Company**

A company has emerged as a form of business organisation and occupies a predominant place in the modern industrial era chiefly because of its superiority over other forms of business organisations such as partnership, individual ownership, etc. Its growth has been accelerated by its prominent characteristics, namely, its identity as a legal person distinct from its members and the limited liability of its members. No wonder, therefore, the companies meet special treatment under the Income Tax Act as well.

Under the Income Tax Act, a 'Company' means any Indian Company or any body Corporate incorporated by or under the laws of a country outside India or any institutions, associations or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of Central Board of Direct Taxes to be a Company. Therefore, any entity, not being a company within meaning of the Companies Act can be treated as a company for the purpose of Income Tax Act if so declared by the Central Board of Direct Taxes.

Tax Rates

For the purpose of levy of tax, Companies are broadly classified as:

a) Domestic and foreign company, and

b) Company in which public are substantially interested and company in which public are not substantially interested.

As mentioned earlier, these rates keep varying every year as per the financial and taxation policies of the government.

Special benefits

Certain provisions of the Income Tax Act confer benefit only to corporate assesses.

There are in respect of inter-corporate dividends and royalty etc. received by an Indian Company from certain foreign enterprises. As per provision amended by the Finance Act, 1990, dividends received by a domestic company from another domestic company are deductible from the total income upto the amount which the receiving company has distributed as dividends. Earlier the deduction was restricted upto 60% of the dividend received and balance was taxable as business income.

Similarly, if an Indian Company receives any royalty, commission, fees or any similar payment from the Government of a foreign State or foreign enterprise in consideration for the use outside Indian of any patent, model, design, formula, process, etc. provided by the Indian company. Then 50% of such consideration brought to India is deductible from the total income of the receiving company.

v) **Wealth tax and Gift tax**

Finance Act, 1983 revived in a limited way, the levy of wealth tax on companies which was suspended by the Finance Act, 1960.

As per Section 40 of Finance Act, 1983 wealth tax is chargeable on the net wealth of every company except a company in which the public are substantially interested at the rate of two per cent of such net wealth.

Further, this section provides that only certain specified assets like precious metal, precious or semi-precious stones, ornaments and utensils of these precious metals and stones, land other than agricultural land, motor cars etc. will be included in the net assets of a company for the purposes of levy of wealth tax.

Therefore, it can be said that companies in which public are substantially interested are not liable to pay wealth tax at all whereas, wealth tax an other companies in chargeable only in respect of certain specified assets which are usually non-commercial assets. **Here again it is suggested that one must take into account the recent steps taken by the government.**

9.8 MAKING THE SELECTION

Having understood the various forms and their relative advantages and disadvantages, you are in a position to finally decide upon the form you want to have for your enterprise. What are the decision variables that you would like to evaluate these various forms on?

Following are some of the variables that you might consider:

1) **Your personal characteristics**: An entrepreneur's psychological build up affects his or her capacity to get along with others. This also includes one's venturesomeness, attitude to risk and uncertainty and capabilities to shoulder responsibilities among other things. Depending upon whether you are type of person who would like to go it alone or venturesome enough to try out something on your own, you might like to choose the form or organisation that allows you the freedom of decision-making. On the other hand, if you like working with others and happen to have big perceptions of risk than you might like to share the risk of enterprise with others. These characteristics may also affect your appreciation of characteristics like unlimited liability and temporary existence.

   Apart from the personal characteristics, your risk taking capacity in terms of personal assets and credit rating would also affect your perception of risk inherent in these forms of organisations, their capital formation potential and the liability scenario.

2) **Your plans for expansion**: While choosing a form of organisation you would have to bear in mind your future plans regarding expansion and growth. As a sole proprietorship offers limited expansion possibilities it may have to be deferred as a choice in favour of the two other forms of organisation.

3) **Needs for raising capital now and in future**: Closely related to the point of expansion is the point of your capital needs, both present and future. In case the enterprise requires low capital outlays in present but heavy outlays in future, you would like to choose a form which facilitates the raising of capital to meet your future requirements – for example, if both present and future capital outlay requirements are high you would go in a form of organisation which enables a larger amount of capital to be brought into the organisation. For example, a Company or a partnership.

4) **Need for continuity of the enterprise**: If the project envisaged by you is a relatively short-term project, you can choose any form of business organisation.

On the other hand if it is a long-term project, you would not like any contingency to threaten the continuity of your business and should choose a form that enjoys stable existence.

5) **Tax adjustment**: No one form of legal organisation can claim the best tax advantage in all instances. You have already studied the differential tax rates applicable to these forms of organisations. It is , however, important to underline one important difference between these forms while computing the taxable income of the organisation. In proprietorships and partnerships any withdrawals of cash by owners during a particular financial year, even in the form of salary, are considered to be withdrawals of capital for tax purposes. In closing the books at the end of the financial year such amounts cannot be recorded as operating expenses of the business. Proprietors and partners pay income tax on the total profit shown irrespective of any withdrawals made during the year. In case of a company, since it is an artificial person, it is considered a separate unit and owners of small enterprises who operate as companies can charge reasonable salaries to the business and these become the operating expenses of the company. They are accordingly deducted while calculating the net taxable income of the company. It is the remaining income which is taxed. The person drawing salary files a separate return and pays personal income tax on his or her incomes. You might like to consider these and related tax implications while choosing the form of your organisation.

Check Your Progress–2

1) Discuss the characteristics of a company.

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2) Discuss the advantages of Proprietorship.

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9.9 LET US SUM UP

Most entrepreneurs when they plan to go into a business of their own, do not have a very clear idea of the relative merits and demerits of choosing one legal form of organisation over another. The sole proprietorship has the great advantage of your being your own boss and total autonomy, but it is also characterised by unlimited liability and possible limitations of size through limited owner resources. Partnership offers the advantage of pooling the human and non-human resources if more than one person, ease if formation and tax advantages, but has the limitation of temporary life, unlimited liability and non-transferability of interests. Similarly, while the company form of organisation offers you the benefits of perpetual succession, limited liability and transferability of interest, entrepreneurs may feel hampered by a far greater amount of legal formalities regarding formation and management and the incidence of possible higher taxation. You must weigh all these and other relative characteristics of these organisational forms carefully before you choose a form of ownership for yourself.

9.10 CLUES TO ANSWERS

Check Your Progress–1

1) See Sec.9.2.

2) Base your answers on Sec.9.4.

Check Your Progress–2

1) These have been discussed in Sec.9.5.

2) See Sec.9.6.

Activities
1. Visit a travel agency and find out the form of organisation that they have.
2. Visit a firm and find out its form and various legalities that it needs to follow.