

TOPIC 12: BUSINESS ENTITIES - QUESTIONS & ANSWERS

1. What are business entities?

Business entities are legal organizations that exist by virtue of state law. One way to view a business entity is as a separate person. The business entity carries on business activity on its own behalf. The owners of the business entity are representatives of the entity. Business entities benefit society by allowing individuals to aggregate their resources and efforts in furtherance of a business activity. The legal entity is essentially a bundle of contracts that provides for the rights and duties of the owners and employees of the business entity. Each individual state passes its own substantive and procedural laws regarding business entities. A business must choose its state of formation or organization. The home state may be the location where the business is headquartered or it may be any other state where the business organizes and establishes a registered agent. If the business wishes to carry on business outside of its home state, it must qualify to do business and register as a “foreign” entity doing business in the other state. Carrying on business is generally defined pretty broadly to include marketing or sales activity. A business may carry on the majority or all of its business in a state or states where it is registered as a foreign entity. The business entity must comply with the laws of any state in which it does business.

- *Example:* I want to form a business entity in my home state of New York. The rules prescribed by New York will govern the formation process. I want to also carry on business in Pennsylvania. To do so, I will register my business in New York and then register as a foreign entity doing business in Pennsylvania.
- *Discussion:* Think about major businesses within the United States. Can you identify five major businesses (Fortune 100 Businesses) within the United States and the state in which they are formed? Where is the headquarters locations of each of these businesses?
- *Practice Question:* Martin is from Mississippi. He forms a business entity and begins providing charter fishing services. He wants to expand his operations to Louisiana. Can you do that given that he is organized in Mississippi? How or why not?
- *Resource Video:* <http://thebusinessprofessor.com/what-are-business-entities/>

2. Why is studying business entities important?

Owners and managers of a business seek to organize their resources to maximize productivity and opportunities. These individuals must understand the important characteristics of the business entity to take advantage of all of the benefits associated with carrying on a business activity as a legal entity. Taking advantage of a business entity status means choosing an entity form for your business, operating within your chosen entity form, and undertaking business transactions with various entity types. Understanding business entity characteristics includes familiarizing one’s self with the ownership structure, organizational structure, potential liability, compensation methods, and tax laws applicable to the business entity. Lastly, the owners and managers of a business must comply with the procedural and substantive laws applicable to that business entity. This is generally known as business governance.

- *Note:* Numerous other requirements may exist before a business entity may carry on business in a jurisdiction. For example, she will likely have to obtain a business license from the local government before undertaking business. She will have to do a fictitious name filing if she

operates under a name other than her own name. Further, she will need to set up an employer identification number (EIN) if she plans to have employees for her business. All of this is distinct from the nature and characteristics of the business entity.

- **Discussion:** Try to outline the procedural steps necessary to form a business entity within a state. This will likely require you to go to the Secretary of State's website for your particular state. The process and rules for form any business entity type will be explained there. *Note:* The process may vary slightly, for each state.
- **Resource Video:** <http://thebusinessprofessor.com/why-is-understanding-business-entities-important/>

3. What is the difference between a closely-held and a publicly-held company?

Business entities are often categorized as either closely-held or publicly-held. These designations are not a separate types of business entity; rather, they are classifications or defining characteristics of a given business. Generally, the distinction between the two classifications concerns the number of business owners and whether the equity ownership is sold on a public exchange.

- **Closely-held Business** - A closely-held business, as the name implies, is held by a smaller or more closely related group of individuals. It is often thought of as a smaller business, such as a mom-and-pop or family business. In truth, however, the closely-held status has little to do with the size or revenue of the business; rather, it simply means that the business is not widely owned by numerous, unrelated people. Another characteristic of the closely-held entity is that it is not traded on a public market.
 - *Example:* My wife, three friends, and I own a business that specializes in dog training and boarding. We are a closely-held business because all of the ownership is held by a small group of closely-connect individuals.
- **Publicly-held Business** - A publicly traded business is any business that is traded on a public exchange. This means that the company has gone through an initial public offering in which its shares were registered with the Securities and Exchange Commission and subsequently listed for sale to the public at large. A publicly-held or publicly-traded company is generally held, or capable of being held, by a large number of unrelated people.
 - *Example:* Elton's business is growing rapidly. He needs to bring in additional capital to expand operations. He decides to undertake a public offering and list shares of his company for sale on a public exchange. Once listed for sale to the public, Elton's business is now a publicly-traded company.
- **Note:** A closely-held business is a private business. It is unlikely that a business could or would undertake a public offering and remain closely held. The inverse, however, is not necessarily true. Private business entities are not necessarily closely held. Some private businesses are widely held by a large number of shareholders.
- **Discussion:** Some companies choose to remain closely-held instead of seeking a large and diverse set of owners. Other companies prefer to be widely held and often undertake a public offering as part of that effort. Can you think of reasons why a company would prefer to remain a closely-held private company versus a widely-held public company?

- **Practice Question:** Can you identify a very large closely held company that does business across the United States? Can you identify why the company is considered, “closely-held”.
- **Resource Video:** <http://thebusinessprofessor.com/closely-held-vs-publicly-held-business/>

4. What are the main types of business entities?

The main types of business entity discussed in this chapter are:

- *Sole Proprietorships* - The sole proprietorship is not considered a separate business entity, but it is the basis from which business entities are defined.
- *General Partnerships* - The general partnership is the most basic type of business entity. While the general partnership is commonly understood to be a legal business entity, some legal theorist do not regard the partnership as a formal legal entity.
- *Limited Partnerships* - This is a hybrid form of partnership, that allows for a class of partner known as a “limited partner”.
- *Limited Liability Limited Partnership* - This is a hybrid form of partnership that allows professional practitioners to organize as partners with limited personal liability.
- *Limited Liability Companies* - This is the most common form of business entity in the United States. The reason for this fact is based upon the characteristics of the LLC.
- *Corporations* - The corporations is the oldest form of business entity. The corporation is generally divided based upon its tax status as C-Corporation, S-Corporation, and Non-Profit Corporation.

Some of the less-common types of business entity are the limited liability limited partnership (LLLP) and the professional corporation (PC). The LLLP is a special purpose entity generally used as part of special project, such as a real estate project. A professional corporation is a corporate form for small practitioner firms that is rarely used because of the unfavorable 25% flat corporate tax rate.

5. What are the main characteristics of a particular business entity?

There are numerous characteristics that make a business entity unique. The major characteristics of a business entity are as follows:

- *Creation & Maintenance* - The effort associated with forming and maintaining the entity;
- *Continuity* - The continuity or stability of the organization upon given occurrences;
- *Ownership & Control* - The ownership rights and control of those involved with the business;
- *Personal Liability* - The potential for personal liability of those involved with the business;
- *Compensation* - The compensation and division of profits among business owners; and
- *Taxation* - The taxation of the organization’s earnings and its distribution of profits to the owners.

This list is certainly not exhaustive; however, these primary characteristics provide a great deal of

necessary insight for understanding and choosing a business entity.

- **Discussion:** Why do you think these are the primary characteristics of a business entity? Can you think of any other characteristics of the business entity that would be important to understand when selecting and forming a business entity.
- **Resource Video:** <http://thebusinessprofessor.com/considerations-in-selecting-business-entities/>

6. What is creation of a business entity?

Creation of a business entity is the legal or procedural steps that one must undertake to bring the business entity into existence. There is a general dichotomy in the process or steps required to form a business entity.

Default Entity Status

Some business entities may arise by default without any formal procedural undertaking by the founder. That is, the business entity may arise simply by the parties undertaking some business activity with the intention of generating revenue or making a profit.

- **Example:** To form a general partnership, the only requirement beyond the physical activity of the founders is the subjective intent of the partners with regard to the responsibilities of each party and the allocation of proceeds (or losses) as they arise. Generally, in the event of dispute, a court will be charged with determining whether individuals carrying on commercial activity are a default general partnership. Notably, the sharing of losses is the greatest indicator of co-ownership of a business, as apposed to an employer-employee or contractor relationship.
- **Note:** In some cases a court may determine that a business entity exists pursuant to the conduct or actions of the parties and that recognition of partnership status is needed to avoid an inequitable result if an entity does not exist. This is known as “estoppel”.

Filing for Entity Status

Some business entities require a formal filing process through the Secretary of State’s office. This requires the filing of documents of organization in accordance with the procedural rules adopted by the state of organization. The amount of information and type of document(s) required will vary between states and depend on the type of entity. The general requirements for each business entity type are discussed along with that business entity.

- **Example:** Eric wants to form an LLC. He goes to the website for the Nebraska Secretary of State’s Office and downloads the necessary forms. He files the information sheet and articles of organization and pays the applicable fee. Seven days later he receives a Nebraska state certificate of organization for his LLC.
- **Discussion:** Most people do not realize the commercial activity by two or more individuals defaults to a business entity status under certain conditions. Can you think of any consequences that this may have for the partners and business activity? *Hint:* think about the characteristics of a business entity discussed above. These will help give you an idea of the potential consequences of being deemed a legal business entity.

- **Practice Question:** Eric is thinking about forming a business entity for his personal consulting practice. He has been consulting for several months and is bringing in Audrey, also a consultant, as a co-owner of the business activity. He and Audrey begin operating their consulting practice before filing the applicable business organization documents. What should Eric and Audrey know about their current business entity status?
- **Resource Video:** <http://thebusinessprofessor.com/creating-business-entities/>

7. What are the maintenance requirements for a business entity?

Maintenance of a business entity is summarized as the administrative steps associated with starting and carrying on business as a given entity form. It entails the process of filing documents, holding meetings, maintaining records, observing formalities, and reporting necessary information to regulators. The requirements for starting a business vary considerably between entity types. Businesses entities that require formal procedures to organize also require formalized maintenance procedures. At the most basic level, these entities require the owners to file statements each year (along with annual fees) with the Secretary of State's office, to hold business meetings, to maintain records, and to report information to regulatory authorities. The state may require that an entity maintain certain records, such as meeting minutes and resolutions, ownership logs, capital accounts, financial statements, etc. The federal government may require that business entities file specific information related to taxation or securities issuances. State and reporting requirements can also be industry specific or based upon the company's size or status as privately or publicly-held.

- **Example:** A group of friends and I form a corporation. We all vote and elect each of us as directors. We then appoint me as CEO. Our creation and maintenance requirements mean following the state-required duties for filing annual information and paying fees to the state. This could include voting as directors to approve our corporate documents. As CEO, I will be charged with filing those documents with the state.
- **Note:** Generally, default business entities require little or no maintenance to continue on as a business entity. These businesses arise simply through the conduct of those involved and do not involve the formalized procedure for maintaining their operating status. While there are few formal maintenance requirements for default entities, there are still numerous tax formalities to follow. The lack of formal maintenance requirements associated with default entities often causes the owners to fail to follow other business formalities.

- **Discussion:** Why do you think the government requires business entities to undertake these maintenance formalities? Why do you think it is important internally for businesses undertake formal maintenance? Which State and Federal agencies do you think the care about business maintenance? Hint: Think about taxation and securities law.
- **Practice Question:** Visit your state's secretary of state's website. Can you locate the information and filing required to form and maintain each type of business entity recognized by your state? How do these requirements vary between each type of business entity?
- **Resource Video:** <http://thebusinessprofessor.com/maintenance-requirements-for-a-business-entity/>

8. What is continuity of a business entity?

The continuity of the business entity concerns the effect on the business of a major change in the ownership and organization structure. More specifically, this question addresses what types of conduct by business owners can cause the business to dissolve. Owners of a business entity must understand the stability and durability of the organization if or when an owner leaves the business. Managers are concerned with the stability of customers and suppliers and should make certain that changes in ownership or structure do not have unintended consequences on the business operations. The primary change affecting the status of a business entity is the death or dissociation of an owner. In some instances this occurrence may be grounds for the dissolution of the business. Another dissolution event may arise through a limitation on the transfer of ownership by any individual in the business. Such a scenario may effectively dissolve the business if one individual wishes to liquidate her interest.

- *Example:* Mary, Bob, and I start carrying on business as a general partnership. We do not have a partnership agreement. When Mary decides to leave the partnership, the default rule is that the partnership dissolves.
- **Discussion:** Can you think of any situations where a business has faced serious turmoil when a co-owner leaves the company? Passes away? Declares personal bankruptcy? What were the primary issues and what was the result?
- **Practice Question:** Mike and Bryan are partners in a business venture. They have a partnership agreement. Bryan passes away and his will leaves his interest in the business to his wife, Jane. What information do you need to know to determine the status of the business entity? Why?
- **Resource Video:** <http://thebusinessprofessor.com/continuity-of-business-entities/>

9. What is the ownership structure for a business entity?

Ownership structure concerns the internal organization of a business entity and the rights and duties of the individuals holding a legal or equitable interest in that business. As owner of the business entity, it is important to understand how the ownership structure of a particular business entity is organized and what that means for the owner's rights.

- *Example:* A shareholder, as owner of a corporation, has certain rights. These rights are distinct from those of members of a limited liability company. Further, within the corporation, a holder of preferred stock may have different rights than the holder of common stock.
- **Discussion:** Why do you think different types of business entity allow for unique ownership structures? Why do you think ownership structure is so important for business owners?
- **Practice Question:** Can you think of any situation where ownership of the business entity became an issue between the founders or co-owners of the businesses? What was the basis of the dispute and what was the outcome?
- **Resource Video:** <http://thebusinessprofessor.com/ownership-structure-of-business-entities/>

10. What is control over a business entity?

This questions concerns who has control over operations or authority to act on behalf of the business.

Each business entity type has a default control structure and level of authority vested in individuals in those roles. In many cases the owners and managers of the business are the same people. This relationship becomes convoluted when there are owners who act as managers of the business and others who do not. The issue of overlapping ownership and control becomes increasingly important in closely-held business entities. Third parties dealing with a business entity want to be certain about the level of authority of the individual with whom they are dealing. Further, the business entity is concerned about its agents undertaking transactions that obligate the entity, such as taking out loans or entering into purchaser or sales contracts.

- *Example:* Owners of an LLC are known as members. I am a member of an LLC. If I am a member-manager of the LLC, then I have the authority to carry on all operations and act on behalf of the LLC. If I am not a manager of a member-managed LLC, then I do not have the authority to act on behalf of the business.
 - *Note:* Recall from the chapter discussing agency law, the level of authority of individuals acting on behalf of a business entity affects the potential liability of the business for the acts of those agents. Business owners may undertake procedures to outline the role and authority of each member of the business. This is normally done within the business's organizational documents. The title attributable to any owner affects the level of control and authority that she has. Failure to follow procedures to document the authority and control within the business can result in a default level of control or authority in a member of the business that is undesirable to the other owners. Further, a lack of formalized organizational structure can cause internal disputes that affect the operational efficiency of the business.
- *Discussion:* Why do you think structure of control is an important characteristic of a business entity? Should business owners be able to change or modify a business's control structure? Why or why not?
 - *Practice Question:* Can you find a situation where an employee or agent acted on behalf of a business without authority? Can you identify a situation where the business was contractually bound by the actions of the employee that were not authorized?
 - *Resource Videos:* https://www.youtube.com/watch?feature=player_embedded&v=stE8FL1Ljdo

11. What is the potential personal liability of owners of a business entity?

Generally, individuals are responsible for their own conduct. The rules of agency may make an individual vicariously responsible for the acts of an agent, if that agent is acting with authority or within the scope of their employment. Some business entities limit the liability of business owners for the actions of agents of the business. This means that the owner is protected from being held personally liable for the debts (contracts) or tortious conduct of the business's employees or other owners. That is, the business owners does not risk losing her personal assets for debts created or tortious activity committed by the business or its owners. This business entity characteristic is a strong motivation for individuals to form a business entity to carry on their business activities. T

- *Example:* The owner of an LLC has two employees who deliver goods to customers. One of the employees accidentally crashes the company vehicle into a pedestrian. The pedestrian can sue the negligent driver and the LLC for damages. The driver may be personally liable for his negligent driving. The LLC may be vicariously liable for the employee's tortious act, since it was committed when the employee was acting in furtherance of the business's operations. The owner's personal assets, however, may be protected from the reach of the plaintiff.

- *Note:* It is important to remember that a business entity offering personal liability protection to its owners may forfeit that protection if the Secretary of State's office or the court disregards the business entity. The Secretary of State may dissolve a business entity for failing to follow entity maintenance requirements. More commonly, a plaintiff who is suing the business may attack the business entity status in an attempt to "pierce the veil". Piercing the veil is discussed further in the corporate governance chapter.
- **Discussion:** Can you identify any situations where the owner of a business has been held personally liable (either in contract or tort) for the actions of the employees of a business? Why was the business owner held personally liable despite the limited liability protections of the business entity?
- **Practice Question:** Bert is a member of an LLC. The LLC is managed by Victoria, also a member of the LLC. Victoria accidentally rear-ends Gayle while driving to meet a business client. If the plaintiff decides to sue for the negligent act, will Bert or Victoria potentially be personally liable?
- **Resource Videos:** <http://thebusinessprofessor.com/limited-liability-business-entities/>

12. How is an owner of a business compensated?

The owners of a corporation may be compensated in two primary manners. The acceptable method of compensation depends upon the type of business entity and is affected by the role that the owner plays in the business. Some business entities allow business profits to pass through the business directly to its owners. These owners receive either a percentage of the profits based upon their ownership percentage or a percentage based upon a special allocation of business profits that differs from their ownership percentage. Other business entities (specifically corporations) compensate owners by distributing dividends from business profits. Unlike flow-through profits, payment of dividends is generally a decision by the board of directors and does not represent all profits of the corporation. That is, the corporation determines the amount of any dividends paid to shareholders and may retain any percentage of profits within the corporation.

- *Note:* A corporate employee who is also a business owner must receive a reasonable salary for her services to the corporation. Otherwise, a portion of any share of corporate profits distributed as dividends will be treated as salary. This makes a difference in how the funds are taxed to the individual. An owner of any other type of business entity does not receive a salary and is compensated by receiving a distribution of profits.
- *Example:* I am a shareholder and CEO of ABC Corp. I will receive a salary for my services as CEO, and I will receive a dividend if any are paid to shareholders. Corporate business entities (or business entities taxed as corporations) require that an owner who also serves as an employee of the business to draw a salary from the business. The salary is separate from any distribution of dividends.
- **Discussion:** Is it common for owners of a business to also serve as employees of the business? Are most owners of a business in the US employees of the business? Please explain.
- **Practice Question:** Frank and Judy are members of an LLC. Both Frank and Judy work in the LLC and each is a 50% owner. What other information do we need to know to determine how Frank and Judy are compensated?

- **Resource Videos:** <http://thebusinessprofessor.com/compensation-within-business-entities/>

13. How are business entities taxed?

Understanding basic taxation concepts as they apply to each entity type will give you sufficient background to understand the important tax considerations in a transaction by a given business entity. To understand taxation of business entities, it is important to understand personal taxation as well as business taxation.

Individual Taxation

Individuals pay Federal and State taxes on a percentage of their adjusted gross income (AGI) in a given tax year. AGI is calculated as an individual's gross income, minus all deductions (either the standard deduction or itemized deductions) and the individual's personal exemption. A person's gross income is comprised of wages or other income, dividends, and investment interest, gains, dividends, rents, royalties, etc. Deductions are numerous categories of expenses that the State and Federal Government exempts from taxation. A person can either claim individual deductions, known as "itemizing deductions" or claiming a "standard deduction".

- *Note:* The standard deduction in 2014 is \$6,200. Each taxpayer also has a personal exemption is \$3,950. The state and federal governments also allow various credits that subtract directly from the amount of income tax liability.
- *Example:* Each year I am required to tally all of my earnings from a number of sources. I then subtract all deductions allowed by the state and federal governments. If my individual deductions do not add up to an amount greater than the allowed standard deduction, I will subtract the standard deduction. This amount is my AGI. Calculation of my income tax liability for the year will be based upon this amount.

The income tax rates for wages and other income are tiered. All individuals pay a fixed percentage on the first several thousand dollars of their AGI, a fixed percentage on the next several thousand, etc.

- *Note:* The 2014 federal tax brackets are 10, 15, 25, 28, 33, 35, and 39.6%. The dollar amount of income that fits in each bracket depends upon whether the individual files as a single taxpayer, married filing separately, head of household, or married filing jointly.
- *Example:* Assume the rates stated above apply. I am not married and file as a single tax payer. I make \$30,000 in a year in wages. I take the standard deduction. My AGI is \$19,850. The first \$10,000 will be taxed at 10% for a liability of \$1,000. The remaining \$9,850 will be taxed at a 15% rate for a liability of \$1,477.50. My total federal tax liability for the year is \$2,477.50. Note that this overly simplified example assumes that I have no additional deductions for state taxes, medicare or social security payments that would reduce my taxable income amount.

Individuals also pay taxes on gains. Gains consist of value received and recognized when an asset is sold for a higher value than the owner's basis in the property. Long-term capital gains (gains on certain assets held longer than 12 months) and dividends are taxed at different rates than other forms of gross income. Short-term capital gains are taxed at ordinary income rates. The tax rate for long-term capital gains and qualified dividends may also be tiered based upon income. While they are included in gross income, qualified dividends and long-term capital gains are subject to different tax rates from other sources of income.

- *Note:* In 2014 long-term capital gains and qualified dividends are taxed at 0, 15, and 20%. The

0% rate applies to individuals in the 10% and 15% income tax brackets. The 15% rate applies to individuals in the 20, 28, 33 and 35% income tax brackets. The 20% rate applies to individuals in the 39% income tax bracket.

- *Example:* I purchase a single share of stock in ABC Corp for \$5. Six months later I sell the stock for \$10. I have gains of \$5. Because I held the stock for 6 months, the gains are treated like wages and taxed at that rate. If I had held the stock for longer than 12 months, then the applicable tax rate would have been the applicable long-term rate.

Business Taxation

Business taxation is more complicated than individual taxation. Business entities are either not taxed at all, or they are taxed at a corporate rate. If a business entity is classified as a pass-through tax entity, then it does not pay income taxes. Rather, the business owners pay taxes on any business profits. Restated, the profits or losses from the business activity pass through to the individual and are reported on her individual income tax form. Businesses that pay taxes, such as businesses taxed under Subsection C of the Internal Revenue Code, are taxed at the corporate rate. Like the individual tax system, the corporate tax rate is tiered.

- *Note:* In 2014 the applicable corporate tax rates are 10, 25, 34, 39, 34, 35, 38, and 35%, depending upon the amount of taxable corporate income.
- *Example:* I form an LLC. I can elect with the IRS for the business to either be taxed as a partnership or a corporation. If I elect to be taxed as a partnership, the LLC will be taxed as a flow-through tax entity. The business entity will not pay income taxes; rather, all profits or losses will flow directly through to me and I will report the income on my personal income tax return and pay the applicable taxes.

Business entities taxed under Subsection C of the Internal Revenue Code (IRC) pay income taxes on profits. Corporations taxed in this manner are known as C-corporations. These taxes are treated as an expense to the corporation. They are deducted, along with other expenses, to determine whether the corporation is profitable or has profits at the end of the tax year. Any distribution of corporate profits to shareholders is a dividend and is taxed to the shareholder at the applicable dividend rate. The shareholder reports those dividends on her personal income tax return.

- *Note:* A business taxed as a C-corporation is not required to distribute profits. These are known as retained earnings. A shareholder does not pay taxes on the income until it is distributed. In a pass-through entity, the business entity does not pay taxes. As such, owners of the business must pay taxes on the profits whether the profits are distributed or no.
- *Example:* I form a corporation and elect to be taxed under Subsection C of the IRC. The corporation brings in \$12,000 and has expenses of \$2,000 in the tax year. The corporation has taxable income of \$10,000. The applicable tax rate is 10% on this amount, equalling \$1,000. So, after taxes, the corporation has profits of \$9,000. If the corporation decides to pay a dividend to me as the sole shareholder, then I will report the dividend payment on my personal income tax return and pay taxes on the dividend amount. If, however, the corporation decides to retain all of the earnings and not pay a dividend, I will not be taxed on the profits. In contrast, in a flow-through tax entity, the business entity itself would not pay taxes. Rather, all \$10,000 of profit would automatically flow through to me. I would report the entire amount on my personal income tax return and pay the applicable taxes.

- **Discussion:** Can you think of a situation where an individual would be subject to a personal income taxes on a portion of the money received from a corporation and subject to dividend taxes

on other amounts of money received? Please explain.

- **Practice Question:** I am an employee and shareholder of ABC Corp. I draw a salary of \$30,000 from the corporation. At the end of the year the corporation has a profit of \$100,000. It decides to pay dividends to shareholders. Based upon the shares I own, I receive dividends of \$1,000. In this scenario, what taxable income must be reported to the federal government?
- **Resource Video:** <http://thebusinessprofessor.com/taxation-of-business-entities-explained/>

Sales Tax

Businesses that sell any sort of good are subject to sales and use tax. Sales tax is the amount that the merchant must charge to customers who purchase goods for use (rather than resale). Sales tax is generally a fixed percentage of the value of the good. Other taxes that accompany sales tax may also apply for specialty occupations, such as merchants selling luxury goods, hotels, and restaurants. The merchant must collect the tax from the customer and not simply pay the taxes from the proceeds of the sale. The taxes withheld must be deposited with the state's department of revenue on a regular basis. The taxing state is the location where the good was sold. It does not matter the location where the seller is located.

- **Example:** I buy widgets from a wholeseller and then resale those goods to the public. Each time a customer purchase a widget for \$10, I also charge the customer 6% sales tax. This means that the final amount is \$10.60. At the end of month, I transmit all sales taxes collected to the state department of revenue in which I collected the taxes. This requires that I keep track of my location when I sold the goods and the location of the customer.
- **Note:** The sales tax rules become tricky when a retailer sells over the internet in state where she does not have a physical business or significant presence. Many states allow that, if the customer is located outside of the state where the retailer is located or has business operations, and the retailer ships the item to the customer, then the retailer does not have to collect and deposit sales taxes. This can be a huge detriment to in-state retailers.

Use Tax

Use tax is a separate tax that is similar to sales tax and applies to the purchase of goods by individuals or businesses. Use tax is assessed when goods are purchased for use or consumption and sales tax is not paid on the item. This scenario may arise when a merchant purchases goods for resale, which is done free of sales tax, and then converts the item to personal use. Another common use-tax scenario is when an individual or business purchases a good in a state other than the state in which the goods will be primarily used, consumed, or located. If the sales tax assessed in the state of purchase is lower than the sales tax in the state where the goods will be used, consumed, or stored, the purchaser must pay the tax rate difference to the state where the good is used, consumed, or located.

- **Example:** Tommy decides to purchase a new truck. He lives in Wyoming, but travels to Montana to purchase the truck. Montana has no sales tax; while Wyoming assesses a 4% sales tax. If he pays \$30,000 for the new truck, he will owe use taxes of \$1,200 to Wyoming, as that is the state where he will use the truck.
- **Discussion:** Can you think of a large corporation that actively negotiates exemption for state sales tax obligations for goods sold via their internet service? Why would a state grant this business relief from collecting sales tax on items sold within the state? How do you feel about the assessment of use tax? What do you think is the reasoning behind this tax?

- **Practice Question:** Aragon is a large online retailer. It is headquartered in Kentucky, but sells and ships consumer goods all across the country. In order to allow for rapid shipping, Aragon builds distribution centers in many states. Aragon ships to customers in State A, which assesses a sales tax, but has no physical presence in the state. Aragon also ships to customers in State B, which assesses a sales tax, but it has a major distribution centers in State B's capital city. Lastly, Aragon ships to customers who have PO boxes in State C, which does not assess sales taxes. These State C customers then take the goods with them for use or consumption in State D. What are the potential sales and use tax assessments in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/sales-and-use-tax-2/>

Self-Employment and Payroll Taxes

Employers and employees who receive any form of compensation as part of their employment are generally subject to payroll taxes. Payroll taxes were authorized under the Federal Insurance Contribution Act (FICA) and are made up of Social Security and Medicare taxes. Employers must withhold these taxes from the compensation paid to employees. The employer then contributes a similar amount to that withheld from the employee's compensation. The employer then deposits these funds with the Internal Revenue Service (IRS). These payments go to fund the Medicare program and the Social Security benefits that the employee will receive when she is eligible.

- **Example:** I go to work for ABC, Corp. ABC pays me a salary. Each pay period, ABC will withhold an amount of income, Medicare, and Social Security taxes. The Medicare and Social Security taxes are known as payroll taxes. ABC will contribute an amount approximately equal to the amount of payroll taxes withheld from my compensation and then deposit those funds with the IRS.

Self-employment taxes apply to individuals who are self-employed or are owners of an entity taxed as a partnership. You can think of it as the employer and the employee are one in the same. As such, the self-employed individual is responsible for paying the employer and employee portion of the payroll tax.

- **Example:** Mary and I form a partnership. We both work in the partnership. As owners of a partnership, we do not receive a salary; rather, we receive compensation by splitting the profits of the business. We are considered self-employed, as we are owners of an entity taxed as a partnership. Mary and I will have to pay self-employment taxes equal to the portion of payroll taxes traditionally paid by an employee and the employer combined.
- **Note:** An employee must fill out form W-4 to provide necessary withholding information, which is then used to determine the amount of income to withhold. The withheld wages serve to satisfy the employee's federal and state income tax obligations. In addition to payroll taxes, the employer will also withhold Federal Unemployment Tax (FUTA) and State Unemployment tax (SUTA) from the employee's wages. She deposits all of the taxes withheld at regular intervals with the IRS or state taxing authority.

- **Discussion:** It is a common scenario where employers wrongfully treat employees as independent contractors. What is the benefit to employers in doing this? What are the detriments to the employee?
- **Practice Question:** Howard and Janet are the sole owner of Searchlight, LLC. Howard and Janet

work in the business and Searchlight has one employee, Taylor. Searchlight is taxed as a partnership. What are Howard and Janet's self-employment tax obligations? What are Searchlight's payroll tax obligations?

- **Resource Video:** <http://thebusinessprofessor.com/self-employment-and-payroll-taxes/>

15. What are the major characteristics of a sole proprietorship?

The sole proprietorship is not a true form of business entity. This is because there is no boundary between the individual entrepreneur and business entity. The entrepreneur and the business activity are one in the same. The sole proprietorship, however, is the basis for comparing other entities. The primary characteristics of the sole proprietorship are as follows:

- *Creation & Maintenance* - To create a sole proprietorship the individual entrepreneur simply has to carry on some activity with the intention of seeking a profit. It is really that simple. It arises when a single individual carries on an activity for a profit (or loss). No formal filing or documentation is required. The definition of a sole proprietorship has two primary components: 1) an activity, and 2) intent to earn a profit. This definition is very broad and covers a broad range of activities. This could make a person's actions or activity into an unintended business entity. The important thing to remember is that the entrepreneur does not have to intend to start a business and the type or manner of activity that she undertakes is irrelevant.
 - *Example:* I am walking down the street and see a house that has lots of leaves in the yard. I need some extra money, so I knock on the door of the home and offer the owner to rake their leaves for \$25. The owner agrees. I am a sole proprietor and have created a sole proprietorship through my efforts.
 - *Note:* The definition of a sole proprietorship can be somewhat misleading, as not every sole proprietorship makes a profit. This requirement is interpreted to mean any sort of activity that intends to generate revenue. There are no maintenance requirements for the sole proprietorship, as it is not true a business entity.
- *Continuity* - If the entrepreneur stops carrying on the business activity, the sole proprietorship ceases to exist. The business entity will exist as long as the sole proprietor wishes to continue doing business. Ownership in the sole proprietorship cannot be transferred because the business activity is unique to the individual. This includes selling the business or passing it to one's heirs.
 - *Note:* The name, property, activity can be transferred, but the actual organizational identity is unique to the individual carrying on the business. The business activity carried on as a sole proprietorship are often passed from owner to owner. This is done by transferring the actual assets of the business.
 - *Example:* I start carrying on business as a sole proprietor. When I am ready to retire, I cannot pass my business to my heirs because the business is inseparable from me. There is no form of stock or ownership interest to transfer. I can, however, sell my naming rights, real estate, and business assets.
- *Ownership* - By definition, a sole proprietorship has one owner.
 - *Note:* A sole proprietorship cannot contain more than one owner or it becomes, by default, a general partnership.

- *Control* - The sole proprietor exercises complete control over the business entity. A sole proprietorship can have employees who work in the business. The key to this relationship is that the employees cannot hold or earn ownership interest in the business activity. This will preclude any profit sharing arrangements between the owner and employee.
 - *Note:* The owner should be careful when compensating an employee based upon the amount of revenue produced. Such compensation should be carefully structured as a bonus system on a base salary.
 - *Example:* I create a consulting business as a sole proprietorship. I employ several people to work for me. I stop working in the business and charge one of my employees with managing the firm. In this scenario, I still have complete control over the business as sole proprietor. The authority I vest in a manager is based upon the complete control I have over the business.
- *Personal Liability* - The sole proprietor is liable for any obligations or torts arising pursuant to the business activity. An individual (employee or business owner) is generally liable in tort for her own actions; however, a sole proprietor is also personally liable for the torts of any employees committed in the course of business operations. This is a form of vicarious liability.
 - *Note:* The personal risk to the business owner is perhaps the greatest disadvantage of carrying on business as a sole proprietor.
 - *Example:* I start a coffee shop and I run it as a sole proprietor. I hire several employees. One day an employee is not paying attention and spills hot coffee on a customer. She sues the employee, the business, and me personally. The employee will likely be liable for her negligent act. Further, the business will be vicariously liable for the acts of the employee. Because the sole proprietorship does not protect the owners for liability for business obligations, I will be personally liable for any judgment rendered against the business. This means that the judgment can be satisfied (paid) from my personal assets (bank account, home, car, etc.).
- *Taxation* - Profits or losses from the sole proprietorship pass through to the business owner. The sole proprietor reports her taxable income on her personal income tax returns (Form 1040 or some variation thereof). The Form 1040 allows the individual to report any income from business operations on their personal income tax return on Schedule C. The sole proprietor does not have to prepare or file a separate tax return for the business entity.
 - *Note:* A sole proprietorship does not withhold income taxes or payroll taxes for its owners. Sole proprietors must withhold and make estimated payments to the IRS and state taxing authority to cover the tax liability attributable to business profits. Further, the sole proprietor must make estimated payments to cover self-employment taxes. The sole proprietor also has to withhold any special business taxes imposed by the state or locality. The withheld taxes must be transferred to the appropriate government agency on the appropriate schedule.
 - *Example:* I carry on business as a sole proprietor. Any business profits flow to me. At the end of the year, I will report the profits on Schedule C of my IRS Form 1040. The sole proprietorship does not file an income tax return. It does not withhold income or payroll taxes for me as owner. I must calculate the profits from the business each month or quarter and pay an estimated amount of taxes to cover my income tax and self-employment tax obligations.

- **Discussion:** Can you identify a business activity where operating as a sole proprietor is not a bad idea? Hint: Think of a combination of the following characteristics: service vs product, employees vs no employees, business premises vs none, business assets vs none, low personal tax rate vs high personal tax rate.
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a sole proprietorship?
- **Resource Video:** <http://thebusinessprofessor.com/sole-proprietorships-explained/>

16. What are the major characteristics of a general partnership?

A general partnership is the most basic form of business entity. The primary characteristics of the General Partnership are as follows:

- **Creation & Maintenance** - A general partnership is an agreement between two or more persons to share a common interest in a commercial endeavor and to share its profits and losses. There is no government filing requirement to form a general partnership. The partnership can arise by default from the actions or activities of the partners. This general partnership definition contains similar elements to the sole proprietorship, but it requires more than one person. The agreement between the individuals does not have to be written or expressed. It can be implied from the actions of the partners. It is important to understand that a general partnership is a default entity. That is, the partners do not have to intend to create a general partnership, nor do they have to realize that a general partnership has been formed.
 - **Note:** In some situations a court may determine that principles of fairness and equity require that the activities of individuals constitute a partnership. This is known as a “partnership by estoppel”.
 - **Example:** I learn about an opportunity to make money raking leaves for a business. I approach Elsa and ask her to help me rake leaves to make money. We agree to split all proceeds from raking leaves. We have formed a general partnership.

Individuals may enter into a written agreement, known as a partnership agreement, establishing a general partnership. A partnership agreement is the governing document for any type of partnership. Partnership agreements are not mandatory, but it is advisable for any partnership to have an agreement governing the partnership relationship.

- **Note:** Documenting the relationship between individuals in a business activity can serve to characterize the relationship as either a general partnership or employer-employee relationship. In the absence of a formal agreement, states have default rules governing the operations of the partnership and the relationship between the partners. While the default rules are comprehensive, they often do not always align with the specific intent of the parties.
- **Example:** If you wish to hire an individual (not bring her on as a partner) and compensate her with a share of the profits, then you will need to document the employment relationship. This may require special structuring of any profit sharing as a bonus paid to the employee, rather than as an ownership percentage in any profits.

A general partnership has no formal maintenance requirements. There are, however, default rules

that provide for the rights of partners with regard to partnership. This may include the right to vote for certain partnership decisions. These rules are a form of governance requirement that may be considered maintenance of the business entity.

- *Continuity* - The duration of a partnership is determined by the intent of the parties. The partners can designate a time period for the general partnership after which, the partnership dissolves. This is known as a “term partnership”. This means that the parties may have some duty to the partnership to remain partners for the pendency of the state time period. If the parties do not designate a specific purpose of time for the partnership’s existence, then it is considered an “at-will” partnership. This means that partners can dissociate from the partnership at any time.
 - *Note:* Partners in a term partnership owe a duty to the partnership, not the other partners.
 - *Example:* I form a partnership with Maria. We specifically state that the partnership will last until the current work project is complete. We have a term partnership and we have a duty to the partnership to remain partners until the completion of the project. If we do specifically state that the partnership ends at the conclusion of our project, then our general partnership is an at-will partnership. We can both leave the partnership at any time without violating any duties to the partnership.

Continuity of the partnership is determined by the partnership agreement. If the parties do not have a partnership agreement stating otherwise, a partnership does not have continuity. That is, the default rule in many states is that a general partner dissolves when a member dissociates. As such, a partnership interest cannot be transferred or passed along to one’s heirs. Most states, however, allow the remaining partners to take steps to reform the general partnership and continue in business after cashing out the dissociating party’s interest.

- *Note:* An exception to the default dissolution rule is when a partner passes away or dissociates by reason of incapacity. In such a case the general partner does not automatically dissolve. The transfer of a general partner’s interest, death or incapacity, may give rise to a right of dissociation by other partners.
- *Example:* I form a partnership with Cliff. We state in the partnership agreement that either party may leave at any time. We include provisions for the continuation of the business and the obligation of the partnership to purchase the leaving partner’s business interest. Without this agreement, the partnership would dissolve upon Cliff or me leaving.

As stated above, partners can change the default rules governing the general partnership by entering into a partnership agreement. The agreement may also designate the procedures for winding down the business or allowing the remaining partners to continue the business. It can further allocate responsibility for debts of the general partnership or allocate the proceeds upon continuation or dissolution. These types of agreements are known as “buy-sell agreements”.

- *Ownership* - General partners are the sole owners of the general partnership. The parties may agree on each partner’s percentage of ownership. In the absence of a partnership agreement, default partnership rules govern the relationship. By default, partners are entitled to equal ownership rights. This means that the partners share equally in profits or losses, unless the parties specifically agree to some other allocation of profits and losses. Further, the default rule is that ownership interests cannot be transferred to third parties without the consent of the existing partners. Attempting an unapproved transfer of an ownership interest is grounds for dissolution of the partnership.
 - *Example:* Katie and I form a partnership. We do not have a partnership agreement. As

such, by default, Katie and I are equal owners of the partnership. We later enter into a partnership agreement that establishes me as a 70% owner and Katie as a 30% owner. This will replace the default rule that we are equal owners.

- *Control* - The general partners have complete control over the partnership. This means that partners have decision-making authority with regard to the governance and strategy of the partnership, as well as authority to act on behalf of the partnership as a general agent. The partners may establish a partnership agreement that changes or limits any partner's right of control or voice in the management of the partnership. This does not, however, limit the authority of a partner to obligate the partnership by entering into transactions or relationships with third parties, such as loan or sales agreements. The partnership can limit the authority of a partner to act on behalf of the partnership by specifically giving any third party notice that the partner's authority is limited.
 - *Note:* Some partnership decisions require consent of both partners.
 - *Example:* Terry and I form a partnership. Terry and I have equal ability to make decision for the partnership. If Terry wants to enter into a purchase contract, then she has the authority to do so. If we decide to limit Terry's authority in a partnership agreement, this does not limit her authority with respect to third parties. I will need to provide notice of that agreement to any third parties who may interact with the partnership through Terry.
- *Personal Liability* - A general partnership is similar to a sole proprietorship in that it does not offer the business owners any form of personal liability protection. Each partner is personally liable for any debts, obligations, or tortious conduct of the business. This means that, if the business stops operating or goes bankrupt, the owners are liable for the debts and obligations of the business. In fact, each partner can be held totally liable for the entire debt of the business. This is known as joint and several liability. Recall the law of agency, the partnership is liable for the obligations established by its agents or their tortious conduct committed within the scope of employment. As such, each partner is potentially personally liable for the actions of partners and employees of the partnership. This may be true even if a partner or employee exceeds her authority under a partnership agreement or employment agreement. These facts alone make a general partnership a potentially risky entity form under which to carry on business.
 - *Example:* Eric and I form a partnership. We hire an employee, Jane. Jane is careless and injures a third party when driving the company truck. The injured party sues Jane and the business. If Jane receives a judgment against the business, Eric and I will be personally liable for the business debt. If the business does not have funds or assets to satisfy the debt, our personal assets will be at risk.
- *Compensation* - General partners are compensated by receiving a draw of partnership funds (generally profits). This is known as the partner's distributive share. By default, this draw is often representative of the percentage of ownership of each partner. The partners may, however, enter into an agreement allocating the distribution of profits or losses differently from the ownership structure. That is, a partner may receive a percentage of partnership profits or losses that is greater than or less than her ownership percentage. This must be justified based upon an economic reality of the partnership, such as one partner spending more time working for the partnership.
 - *Note:* Partners are not entitled to receive a salary based upon their ownership percentage or for services rendered to the general partnership. Only employees of the partnership who are not also partners may receive a salary as compensation.
 - *Example:* Tanya and I form a partnership with equal ownership. We have one employee,

Josh. At the end of the year, the partnership has \$10,000 in earnings. The only expense is Josh's salary of \$2,000. Tanya and I will receive a distribution of \$4,000 each. Josh, who is not an owner, received a salary. It does not matter whether Tanya and I work in the partnership. As owners we do not receive a salary.

- **Taxation** - General partnerships are not taxable entities; rather, they are pass-through tax entities. The partnership will subtract expenses and other deductions from revenue to determine the annual profits or losses. Like a sole proprietorship, partners report their share of general partnership profits or losses on their personal income tax returns. The general partnership does, however, have to prepare a tax return. This return is known as an "informational return" and is filed on IRS Form 1065. The return outlines the revenues and expenses attributable to operations. It will also outline the percentage or amount of the profit or losses to which each party is entitled. The partnership is obligated to provide individual partners with a Form K-1 outlining that partner's share of profits or losses. These amounts are then recorded on the owner's individual tax return.
 - *Note:* A partner is required to pay taxes on her allocated percentage of partnership profits, whether she withdraws the profits from the partnership or leaves those profits in the business entity.
 - *Example:* Barry and I form a partnership. At the end of the year, the partnership has profits of \$10,000. Barry and I are equal partners, so we are each entitled to 50% of the profits. The partnership will prepare and information return and provide K-1s to Barry and me. The K-1 will indicate that we received \$5,000 in profits, which we must report when filing our individual income tax returns.

- **Discussion:** Is there ever a situation when carrying on business as a general partnership is a good idea? Hint: Think about situations where other business entities are the general partners.
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a general partnership?
- **Resource Video:** <http://thebusinessprofessor.com/general-partnership-explained/>

17. What is a joint venture?

Joint ventures operate similarly to general partnerships, but are specifically formed for a limited purpose or a single project. Unlike a general partnership, the joint venture does not arise by default through the activity of the joint venturers. Rather, it requires the specific intent and agreement of the parties. As such, a joint venture agreement should be in writing to avoid the interpretation of the activity as a general partnership. Accomplishing a specific goal or working on a specific project is a key characteristic of the joint venture. If the joint venture is repeated, it makes it more likely that a court would interpret the relationship to be a general partnership. The joint venturers may be individuals or business entities; however, it is most commonly used by two separate business entities to undertake a special project or commercial activity. They are particularly common when one business wishes to expand operations into a new market, such as when expanding sales to a foreign country.

- *Example:* ABC Corp is interested in expanding its product sales into China. China has proven to be a difficult regulatory environment and customer market for US companies. Instead of entering the China market directly, ABC Corp decides to do a test run of its product sales with 123 Corp, a Chinese company. ABC and 123 agree to jointly sell and market ABC's product in China for a 6 month period. At the end of the period ABC Corp can decide if it wishes to enter into the Chinese

market directly or pursue distributor or licensing relationships.

- **Discussion:** Can you identify an example of a prominent joint venture?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-joint-ventures/>

18. What are the major characteristics of a limited partnership?

The limited partnership is a specialized form of partnership. The purpose of the limited partnership is to allow individuals to organize into an entity form that allows the flexibility of a general partnership, while allowing for special rights, duties, and protections for “limited partners”. The major characteristics of the limited partnership are as follows:

- **Creation and Maintenance** - A limited partnership, unlike a general partnership, must be filed with the state government to come into existence. The application must state the purpose of the business and list the name and general contact information for all limited and general partners. Indicating who is a limited partner is important so as not to deceive third parties with regard to ownership and control of the business entity. Forming a general partnership also requires a written agreement between the partners that identifies and indicates the limited partner status of any limited partners. Only one general partner and one limited partner are required; however, there can be numerous limited and general partners.
 - **Note:** The partners must undertake the initial filing process and follow any required updates or filings by state government. This includes updating the records in the event of any change in ownership of the limited partnership, such as the entrance or exit of partners. Further, if a limited partner becomes a general partner, or vice versa, the records must be updated.
 - **Example:** Martin and I decide to form a partnership. Martin wants to be a limited partner and allow me to run the business as general partner. We enter into a limited partnership agreement. We then register the entity with the Georgia Secretary of State's office. In the registration, we identify Martin as the limited partner and me as the general partner.
- **Continuity** - As for continuity, the same rules apply as those of the general partnership. Because the limited partnership will always have a partnership agreement, it generally includes provisions governing the continuity of the business in the event of dissociation by a partner. It will also outline the events that constitute an automatic dissociation event, such as personal bankruptcy of a member.
- **Ownership** - The limited and general partners own the limited partnership in whatever percentage is allocated in the limited partnership agreement. This is the same as in a general partnership. Generally, the default partnership rules regarding ownership do not apply, as the limited partnership cannot exist without a limited partnership agreement that allocates ownership interest. The main difference in ownership interest is how it arises. Generally, the limited partners receive an ownership interest in exchange for providing capital (either funds or physical resources) to the limited partnership; while the general partner generally receives an ownership interest for either capital or labor provided to the limited partnership.
 - **Example:** Clark and I decide to form a limited partnership. Clark will contribute funds to the business and will act as limited partner. I will contribute effort to the business and will be a general partner. Clark and I will have equal ownership of the partnership.

- *Control* - Control is the most defining aspect of a limited partnership. As in a general partnership, general partners in the limited partnership control and have authority to act on behalf of the partnership. Limited partners, on the other hand, cannot take part in management or decision-making of the business. This prohibition includes limitations on taking part in any of the actual operations of the business. More specifically, they cannot exercise control over any activity or anyone carrying out a business activity. A limited partner that exceeds this limited authority may lose her limited partner status and be deemed a general partner. This is a scary proposition for the limited partner, as a general partner is subject to personal liability for the obligations and torts of the partnership, where the limited partner is not. As such, the limited partner is relegated to being a passive investor in the business activity.
 - *Note:* Statutes in some jurisdictions allow a limited partner to take limited part in the following activity without being converted into a general partner: consulting with or advising the general partnership; acting as guarantor of partnership obligations; inspecting or copying any of the partnership records; demanding true and full information about the partnership whenever circumstances render just and reasonable; receiving a share of the profits or other compensation by way of income; approving or disapproving an amendment to the partnership's certificate, voting on matters of fundamental importance such as dissolution, sale of assets, or change of the partnership's name; and having their contribution (investment in the partnership) returned upon dissolution.
 - *Example:* Tammy and I form a limited partnership. Tammy is the limited partner and I am the general partner. As general partner, I am charged with controlling all operations of the business. Tammy, as limited partner, cannot take part in any of the operational decision-making. She can, however, take part in any major business decisions that affect the ownership or structure of the business entity. In essence, Tammy is a silent owner and has no authority to act on behalf of the business entity.
- *Limited Personal Liability* - The key advantage of a limited partnership is that the limited partner has limited personal liability for obligations and torts of the partnership. Specifically, the limited partner is only personally liable for the limited partnership's liabilities to the extent of her investment in the business. She cannot lose personal assets, only the assets that she has contributed to the partnership. General partners, on the other hand, face unlimited personal liability for obligations and torts of the partnership.
 - *Note:* Remember, actively participating in management will cause the limited partner to be treated as a general partner. This means losing the limited liability protection and risking one's personal assets for debts of the business.
 - *Example:* Cary and I form a limited partnership. I am the general partner and Cary is the limited partner. Mark sues the limited partnership for failure to pay a debt. He receives a judgment against the business. If the business does not have the assets to pay or otherwise satisfy the debt, Mark can seek to satisfy the judgment against my personal assets. Cary can lose the assets she contributed to the business, but Mark cannot go after her personal assets.
- *Compensation* - Compensation in a limited partnership is the same as in a general partnership. Limited and general partners are compensated through distributions of profits (partnership draw). It is common for either general or partners in a limited partnership to receive a special allocation of partnership profits that does not coincide with the percentage of business ownership.
- *Taxation* - Limited partnerships are taxed similarly to a general partnership. The profits and losses

of the limited partnership pass through to the owners and are reported on the owners' personal income tax statements. The notable difference between the taxation of general and limited partners is that limited partners receive their distribution of profits as passive income. That is, they have not earned the income pursuant to work effort; rather, it is pursuant to a passive investment. As such, the limited partner's incomes is not subject to self-employment tax (15.6% in 2014).

- *Note:* The general partners must still pay self-employment tax on their share of partnership profits.
- *Example:* David and I form a limited partnership. As general partner, I am active in the business. David, as limited partner, does not actively participate in business operations. At the end of the year, the limited partnership has profits of \$10,000. David's share of the profits (\$5,000) is considered passive income. As such, David does not have to pay self-employment taxes on the income. My profits, in contrast, are active. As such, I will have to pay payroll taxes up on the \$5,000 of compensation allocable to me.

- **Discussion:** Can you think of a prominent limited partnership? Why does the limited partnership entity fit well with this business model?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited partnership?
- **Resource Document:** <http://thebusinessprofessor.com/limited-partnership-explained/>

19. What are the main characteristics of a limited liability partnership?

A limited liability limited partnership (LLP) is a special, hybrid entity recognized in most states. The LLP has characteristics similar to a GP, but has limited liability protections similar to that of an LLC. The main characteristics of an LLP are as follows:

- **Creation & Maintenance** - The LLP, like the limited partnership, arises by filing an application with the Secretary of State's office. Partners are required to have a LLP agreement. Other requirements may include a description of the business and a certification that the business will obtain liability insurance. The LLP must make routine filing similar to that of the limited partnership. Like the limited partnership, there are very few internal governance requirements.
 - *Note:* States generally restrict the LLP entity to certain professions, such as accountants, attorneys, doctors, or other professional service providers.
- **Continuity** - The continuity of the LLP is similar to that of a general partnership. Since there must be a LLP agreement, it normally outlines the process or procedure for dissociation by any partner. In the absence of provisions covering dissociation in the LLP agreement, the default limited partnership rules apply.
 - *Note:* Under certain conditions the dissociation by a partner may give cause for other partners to dissociate. Further, dissociation of a partner may give rise to dissolution of the entity.
- **Ownership** - The partners own an interest in the LLP as outlined in the LLP agreement. Like a GP, the agreement can allocate ownership in any manner. Further, it can make special allocations

of profits and losses, subject to similar tests for economic significance.

- **Control** - Similar to a general partnership, and unlike a limited partnership, each partner in an LLP has the authority to control and act on behalf of the LLP. The LLP agreement may designate partner seniority and managing partners who control the administration functions of the LLP.
- **Limited Personal Liability** - Each partner receives personal liability protection with regard to the actions of other partners, employees, or other agents of the LLP. Specifically, the personal assets of each partner are protected from liability from the actions of others. This relationship allows the partners to enjoy the freedoms and lack of formality associated with a LLP while also taking advantage of limited personal liability protection. As with other forms of partnership, the LLP entity is responsible for the debts and obligations of the LLP. This includes responsibility for the tortious actions of any partner, employee, or other agent of the business.
 - **Note:** A partner (in any type of partnership) is always personally liable for her own actions. Some states limit the liability protection of limited liability partners to negligence actions. In such cases, the other partners are still personally liable for debts of the LLP and intentional conduct of other partners. LLPs are often created specifically to protect partners from liability for the professional malpractice of other partners.
 - **Example:** Carter and Aly are architects and partners in an LLP. Carter works on a large building project and drafts a very poor design. The building is not structurally sound and collapses. Several individual are injured and sue the LLP. The LLP will be liable for any judgment rendered against it. Further, Carter may be held personally liable for his negligent performance. Aly, however, is not personally liable for the debts of the LLP or Carter. While the value of her interest in the LLP may be reduced because of the obligations of the LLP, her personal assets are protected.
- **Compensation** - LLP partners are compensated similarly to general partners. Each partner receives a draw of partnership profits. The amount of the draw is either based upon the partner's percentage of ownership or on a special allocation to that partner.
- **Taxation** - LLPs are taxed similarly to a general partnership. Profits and losses pass through to the partner based upon her share of the ownership or in accord with the special allocation provisions of the LLP agreement. Generally, each limited liability partner is treated as a general partner. As such, income received from the LLP business activity is considered active income. This also means that income imputed to the partners is subject to self-employment taxes.

- **Discussion:** Can you think of a prominent limited liability partnership? Why does the limited liability partnership entity fit well with this business model?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited liability partnership?
- **Resource Video:**

20. What are the main characteristics of a limited liability company?

A limited liability company (LLC) is a state recognized entity that blends the characteristics of a GP and a corporation. The LLC has quickly become the most popular business entity form in the United States for small businesses with more than one owner. The main characteristics of an LLC are as follows:

- *Creation and Maintenance* - An LLC is created by filing articles of organization with the Secretary of State's office. The organizer must be an individual and cannot be a corporation. There must be at least one member of the LLC. If it is only one, it is known as a "single-member LLC". Like other entity filings, the Secretaries of State charge filing fees for registration. Some states require businesses to publish notice of intent to create an LLC. Notice is generally achieved by publishing notice in a local newspaper. The LLC must make annual filings with state and make corrective filings when ownership of the LLC changes. There are very little mandatory governance and maintenance requirements for an LLC. The law does not require the LLC to have meetings or make reports to its owners. Any governance requirements are established by the LLC members and are outlined in the LLC operating agreement. This documents controls the governance and internal operations of the LLC, such as holding meetings, voting rights, keeping of records, etc. At a bare minimum, LLCs must update the corporate records when any major changes take place in the business. This includes changing registered agents, moving addresses, discontinuing operations, etc.
 - *Note:* The limited maintenance requirements of an LLC are a big draw of the LLC over other pass-through tax entities that offer limited liability, such as the S corporation. An operating agreement is not required to form or maintain an LLC, and, in many cases, members of an LLC will not create one. In such a case, the state default rules regarding LLC governance apply to the business entity.
- *Continuity* - An LLC is a separate entity from its owners. The business continues until there is an act of dissolution by the owners. The operating agreement generally lays out the events that give rise to dissolution. It will generally provide for the ability to transfer ownership interest in the LLC, such as at the time of a member leaving (dissociation) or passing it to heirs upon death. The agreement may also determine whether dissociation of a member is grounds for dissolution. If the LLC does not have an operating agreement, the default rules restrict the transfer of LLC interests to outside parties. The default rule in most states is, if a party seeks to transfer her interest or dissociate from the entity, then it is grounds for dissolution of the entity by the other parties. The business dissolves if a member dissociates from the firm, unless the other parties decide to continue the business within a statutory period of time.
 - *Note:* Dissolution requires a winding up of the business. This includes the settling of debts and the distribution of ownership interest to the parties. Most LLCs do not depend upon the default rules and address continuity within the operating agreement or within a separate buy-sell agreement. These documents will specifically outline what constitutes events giving rise to dissolution.
- *Ownership* - The owners of an LLC are known as members. Members hold membership units that are very similar to equity shares or stock owned by shareholders (owners) of a corporation. Each member's ownership percentage is recording in an operating agreement. If the LLC does not have an operating agreement, then the default rule is that all members of the LLC have equal ownership.
 - *Note:* Some states do not require the designation of membership units. These states allow LLCs to record ownership as a percentage. This method is similar to the method of recording ownership in a partnership.
- *Control* - Control and authority to act on behalf of the LLC can be in one of two structural formats. The organizers of an LLC make an election at the time of organization whether the business will be "member-managed" or "manager-managed".

- *Member-Managed LLCs* - Member-managed LLCs are very similar to GPs. Each member has authority to manage and act on behalf of the LLC. The default rule is that each member has equal authority. As such, members should take great care to outline the authority and rights of members in the operating agreement. This can be used to limit the authority of the member-manager. If third parties are aware of the limited authority of a member-manager, then the LLC will not be obligated if the member-manager exceeds her authority when dealing with that third party.
 - *Example:* Derek and I form a member-managed, LLC. We do not have an operating agreement to limit either of our authority. The default rule is that both Derek and I have complete control over LLC operations and unfettered authority to act on behalf of the LLC. If we enter into an operating agreement that limits either of our authority, it is only effective to limit our dealings with third parties if those individuals are aware of the contractual limitations.
- *Manager-Managed LLCs* - Manager-managed LLCs are organized more like a corporation. In such an entity, the members do not have the authority to control or act on behalf of the business. Manager(s) run the business and control the daily affairs. The managers of the business may also be members, or they can simply be employees of the LLC hired to run the daily affairs. The members, however, retain the authority to vote for major business decisions.
 - *Note:* State registration documents generally indicate that an LLC is manager-managed. This should put third parties on notice that a member who is not a manager does not have authority to represent or act on behalf of the LLC. This may provide a defense against any claims of apparent authority if a member attempts to interact with third parties as a manager.
 - *Example:* Veronica and I form a manager-managed LLC. We are both members, but I am designated as manager. As manager, I have total control over the daily operations of the LLC. Also, I have complete authority to interact with third parties on behalf of the LLC. Veronica, as a member, has certain decision-making rights regarding the structure or governance of the LLC, but she does not have authority to manager operations or interact with third-parties on behalf of the LLC.
- *Limited Personal Liability* - The LLC entity provides personal liability protection for its members from the debts and torts of the business entity. Members and employees are agents of the LLC and their actions subject the LLC to potential liability in contract and tort. If an agent breaches an LLC obligation or commits a tort within the scope of employment, a plaintiff may sue the LLC. The LLC (to the extent of its assets) may be liable to the plaintiff. The personal assets of the members, however, are not at risk in the lawsuit. Remember, an individual is always liable for her own conduct. The limited liability protections of the business entity do not protect against personal liability of one's own actions.
 - *Note:* While limited liability is a primary reason for choosing the LLC as an operating structure, it is the subject of a great deal of confusion among business owners. The misunderstanding regards the extent of limited liability afforded by forming an LLC.
- *Compensation* - LLC compensation is based largely on the tax election. Most LLCs choose to be taxed as partners rather than corporation. As such, LLC members are compensated in accordance with partnership principles. That is, an LLC member is not entitled to compensation for their services to the LLC. Rather, they receive a distribution of LLC profits based upon their ownership

percentage in the business or pursuant to some special allocation of profits. These special allocations are subject to the substantial economic effect test by the IRS.

- *Note:* Employees of an LLC who are not owners receive a salary from the LLC. In a manager-managed LLC, managers receive a salary for their services to the LLC. If the manager is also a member, however, she does not receive a salary. A member-manager may, however, receive a higher distribution of LLC profits or special allocation as compensation for services to the LLC.
- *Taxation* - LLCs may choose to be taxed as a partnership or a corporation. See the sections on partnership and corporate taxation for further explanation.
 - *Note:* While the law is being developed, members of member-managed LLCs that are taxed as partnerships generally pay self-employment taxes on their distributions. This is true regardless of whether the member actually takes part in management. Managers in manager-managed LLCs, unless they are also members, receive wages from the LLC. The LLC must withhold payroll taxes and the manager must pay FICA taxes. A manager who is also a member must pay self-employment taxes on any distribution from the LLC, because the income is considered “active income.” In a manager-managed LLC, members who do not actively part in operations argue that their distributions are passive income and not subject to self employment taxes. The IRS has taken the opposite view, but the issue is still largely unsettled.

- **Discussion:** Why do you think limited liability companies have become the most popular business entity within the United States?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a limited liability company?
- **Resource Video:** <http://thebusinessprofessor.com/limited-liability-companies-explained/>

21. What are the main characteristics of a corporation?

A corporation is one of the earliest forms of legally recognized business entity. Corporations exist under every state’s laws. The corporation is the most formalized and developed form of business entity. Its structure is developed to optimize the relationship between owners (shareholders), high level decision-makers (Directors), and operational managers (Executives). The main characteristics of a corporation are as follows:

- *Creation and Maintenance* - Corporations arise by filing articles of incorporation with the state government. The state issues a charter upon the application of individuals known as incorporators. Once the corporate charter is issued, the incorporator must take actions to form the board of directors. Once the board is formed, it must act to ratify the incorporator’s actions, adopt the bylaws, and approve a variety of corporate actions (including the distribution of stock to owners). Once all of these actions are taken, the corporation exists and is ready to carry on business. The articles of organization establish the ownership structure of the corporation and the primary rights of shareholders. The bylaws control the internal governance of the corporation. Corporations require a considerable amount of maintenance and the amount of formality associated with corporate maintenance increases with the size of the business. The purpose of corporate maintenance is to protect the interests of shareholders and third parties dealing with the

corporation. Maintenance formalities include keeping detailed records of all actions taken. This is normally done through director and shareholder meetings or through consents. Both directors and shareholders must hold annual meetings. Special meetings are used for special or pressing topics. Consents are actions approved in writing by directors or shareholders outside of meetings. Most states require that directors undertake major actions of the corporation during an annual or special meeting. Directors generally hold special meetings throughout the year to deal with special issues. At meetings directors and shareholders act through resolutions that are documented by the corporate secretary.

- *Note:* The maintenance and governance requirements are covered in more detail in the Corporate Governance chapter.
- *Example:* William and Jan decide to form a corporation. They prepare the registration documents and the articles of incorporation to be filed with the Secretary of State's office. Once the state issues a certificate of incorporation, William and Jan hold a meeting incorporators and distribute shares to themselves as initial stockholders. They also vote to appoint themselves as CEO and Secretary, respectively. They then proceed to have a shareholder's meeting to vote and confirm themselves as directors. As directors, William and Jan vote to adopt the corporate bylaws and to undertake a laundry list of other corporate actions. The bylaws will contain all of the corporate governance requirements. At the end of the meeting, the corporation is formed and the corporation has established responsibility for complying with the state-required maintenance and the requirements of the bylaws.
- *Continuity* - A corporation exists independently of its owners. Unless the owners undertake an act of dissolution, the corporation will continue to exist. Notably, dissociation by shareholders, directors, or officers of a corporation is not grounds for dissolution. Generally, shareholders may sell or exchange their corporate interest and the business entity continues to exist. Unlike other forms of business entity, corporations have continuity by default.
 - *Note:* If desired, shareholders may vote to add dissolution provisions to the articles of incorporation or bylaws. This will change the default rule that a corporation has continuity independent of the dissociation of shareholders.
- *Ownership* - Corporations are owned by shareholders. Closely-held corporations are held by a small group of shareholders. Non-publicly traded corporations may be more widely held, but shares are not traded on a public exchange. Public corporation shares are publicly traded on exchanges (or in over-the-counter transactions) and are often very widely held. The shareholders are entitled to receipt of any profits of the corporation upon sale or liquidation (after all liabilities are paid). Shareholders may be divided into classes, depending upon the type of shares they own. Most commonly, a corporation will issue two types of shares: common and preferred. Common and preferred shareholders often have different levels of entitlement. The ownership structure of a corporation can be very complex. Corporate boards often authorize various types of preferred shares that carry specific rights. These shares are used to seek certain types of investors or to assure control to certain shareholders.
 - *Note:* Corporate ownership is discussed in greater detail in the Corporate Governance chapter.
- *Control* - Responsibilities within a corporation are divided among three groups, Shareholders, Directors, and Officers.
 - *Shareholders* (owners) - Common shareholders (and sometimes preferred shareholders)

have two primary types of authority. First, shareholders vote to elect the board of directors, and second, shareholders must approve any major corporate actions (e.g., amending the articles of incorporation, increasing authorized shares, adding new classes of shares, dissolving the corporation, entering into a merger, and some stock repurchases). Some of these decisions also require director approval (or at least initiation).

- *Directors* (high level managers) - Directors make high-level and strategic management decisions for the corporation. Basically, the board makes all material decisions that are outside of the ordinary course of business operations. For example, director approval is required for issuing shares, granting options, entering into very large contracts, opening new lines of credit, appointing new corporate officers, purchasing another business, dissolution of the corporation.
- *Officers* (daily operations managers)- Officers are in charge of the daily affairs of the corporation. They account for all business activity not reserved for the directors and shareholders.
- *Limited Liability Protection* - Shareholders have limited personal liability for the obligations and torts of the corporation. Shareholders are only liable to the extent of their investment in the corporation. Assets of the corporation can be used to satisfy such debts, which may decrease the value of the shareholder's equity. Directors and officers are generally not liable for actions taken in the course of business; however, both may be subject to shareholder suits for any actions (or approval of actions) that damage the corporation. These suits are known as "derivative shareholder actions". In this type of action, shareholders sue the directors or officers on behalf of the corporation. Officers and directors are protected from liability from negligent acts in the performance of their duties by a doctrine known as "the business judgment rule". This rule provides that an officer or director may only be held liable for their bad faith conduct. Bad faith conduct includes intentional misconduct or self-serving conduct.
 - *Note:* One special aspect of the liability in the corporation is that of the promoter. A promoter of a corporation is the individual undertaking the task necessary to bring the corporation into existence. She will often enter into forward looking agreements on behalf of the non-existent corporation. Once formed, the corporation will generally adopt this agreement and enter into a novation with the other party. This novation relieves the promoter of liability. If, however, the corporation never materializes or it never enters into a novation with the contracting party, then the promoter remains liable on those contracts executed when organizing the corporation.
- *Compensation* - Shareholders who are not employees of a corporation receive compensation in the form of dividends. Corporations distribute dividends from either annual profits or retained earnings. Distributing dividends is optional and usually done pursuant to a vote of the directors. In some cases, the articles or bylaws may provide dividend rights to certain shareholders. As previously discussed, dividends are taxed at a more favorable rate than ordinary income. Further, dividends (as long as not part of the shareholder's business practices) are not subject to payroll or self-employment taxes. Employees of the corporation, including officers and directors, receive a salary for their services. If a shareholder is also an employee, she will receive a salary for her services and dividends pursuant to her status as shareholder.
 - *Note:* It is a common practice for shareholder employees to receive a low salary but receive more of their compensation as dividends. This practice avoids paying payroll taxes. As such, the IRS requires shareholder employees to receive a reasonable salary for her services to the corporation. If a salary is unreasonably low, some of the dividends

received by the employee may be reclassified and taxed as wages (rather than dividends).

- **Taxation** - Corporations may be taxed either: 1) as a pass-through entity or 2) subject to double taxation.
 - **C Corporation** - A corporations taxed pursuant to Subchapter C of the Internal Revenue known as C corporations. C corporations pay taxes on its profits. Paying taxes as a business entity is known as entity-level taxation. If the profits are distributed to shareholders as dividends, the shareholders must pay taxes on those distributions. This scenario is known as double taxation. Corporate tax rates are discussed above.
 - *Example:* Larry, Moe, and Curly form a corporation and own an equal number of shares. They are all shareholders and directors of the corporation. They elect to be taxed under Subchapter C of the IRC. The corporation has a profit of \$15,000 at the end of the tax year. The corporation will have to pay income taxes on these profits at the corporate tax rate. As directors, Larry, Moe, and Curly decide to distribute the remaining profits (after taxes) to themselves as dividends. They will report and pay taxes on these dividends on their personal income tax returns.
 - **S Corporation** - Pass-through taxation is achieved pursuant to Subchapter S of the IRC. If the corporation meets the necessary qualifications, it can elect to be taxed under subchapter S on a pass-through basis. The corporation is commonly referred to as an S corporation. This method of taxation is somewhat similar to partnership taxation, but there are some notable differences that are discussed in detailed in higher-level tax courses.
 - *Note:* If the corporation fails to qualify under subchapter S, or it does not make an “S election”, it will be subject to double taxation under Subchapter C of the IRC.
 - *Example:* Larry, Moe, and Curly form a corporation and own an equal number of shares. They are all shareholders and directors of the corporation. They elect to be taxed under Subchapter S of the IRC. The corporation has a profit of \$15,000 at the end of the tax year. The corporation does not pay taxes at the entity level. As directors, Larry, Moe, and Curly can decide whether to distribute the remaining profits to themselves as dividends. Regardless of whether the profits are distributed or no, the \$15,000 of profits will pass through to Larry, Moe, and Curly in the amount of \$5,000 each. They will report and pay taxes on these dividends on their personal income tax returns.

Regardless of whether taxed under Subchapter S or C, salaries paid to employees (directors and officers) and payments to contractors are expenses to the corporation that are deducted from income. After-tax distributions of profits to shareholders (dividends) are taxed again to the shareholder. In a C-Corporation shareholders pay income taxes on the dividends received as owners of corporate stock. In an S-Corporation, shareholders pay taxes on their share of annual corporate profits whether distributed or retained in the corporation.

- **Discussion:** Why are most (nearly all) publicly traded companies organized as corporations?
- **Practice Question:** In a short paragraph, can you describe the primary attributes of a corporation?
- **Resource Video:** <http://thebusinessprofessor.com/c-corporations-explained/>

22. What are the requirements to qualify as an S corporation?

To qualify for S-Corporation status, the business must be a corporation and meet the following requirements:

- *Geography* - Organized in the United States.
- *Citizenship* - All shareholders must be U.S. Citizens or resident aliens.
- *Number of Shareholders* - It cannot have more than 100 shareholders.
 - Note: All members of a family are considered to be one investor for purposes of this rule.
- *Eligible Shareholders* - All shareholders must be individuals, trusts, or certain other exempt organizations.
- *Ownership Classes* - The company may only authorize one class of stock (common stock).
- *Tax Year* - The company must follow an IRS accepted tax year.
- *Shareholder Election* - All shareholders must consent to the S-election.

It is fairly easy to run afoul of the S corporation requirements and lose the tax status. For example, a business may exceed the number of eligible shareholders, accidentally transfer an interest in the business to a business entity, or authorize what is deemed a second class of shares.

- *Note:* Certain banking and insurance companies are not eligible for S-corporation status.
- **Discussion:** If a business qualifies for S-Corporation status, is there any reason to choose C-corporation status over S-Corporation status?
- **Practice Question:** Tom is planning a startup venture. He knows that he is going to need outside capital from investors who will purchase an ownership interest in the business. What limiting factors should Tom know about an S corporation when deciding whether to organize as a C corporation or S corporation?
- **Resource Video:** <http://thebusinessprofessor.com/what-are-requirements-for-an-s-corporation/>