

BUSINESS OWNERSHIP STRUCTURES

Sole Proprietor

If you're a handyman or a hair stylist, you typically have to pay for state and municipal licenses, so you might not want to also pay an attorney to set up a corporation or other business structure for you. Therefore, it might be tempting to just run your business as a **sole proprietor**. Perhaps you've noticed that a lot of folks who can fix your plumbing or coif your hair are just doing business as, you know, themselves. Unlike setting up a corporation or other business structure, setting up a sole proprietorship doesn't require much in terms of time and expense. The advantages of opening your business as a sole proprietorship include:

- Faster, easier, cheaper setup (corporations require setup fees, and often attorneys)
- Easy tax preparation (1040)
- Income flows directly to the owner (no separate income tax on the business)

The trouble with being in business as a sole proprietor is that you remain personally liable for the debts and lawsuits against the business. In other words, you have not created a separate legal entity—you and the business are one and the same. If the sole proprietorship called Harry's Hotties accidentally sells 1,000 tainted hot dogs that send swarms of sick people to the emergency room, Harry is in a whole lot of trouble. All the lawsuits will be filed against Harry personally, and the creditors who used to spot him buns, hot dogs, mustard, and relish are going to come after Harry personally for all the unpaid bills. Even if he has insurance, once the insurance is exhausted, the angry parties move directly to Harry, not to some corporate structure that would have added a layer of defense. So, the disadvantages of owning a business as a sole proprietor include:

- Personal liability (no separate legal entity), (big disadvantage)
- Harder to obtain loans or attract investment capital due to lower financial controls (financial statements and minutes not required)

Since a sole proprietor is an individual who owns a business that often operates on a shoestring budget, as an investor he or she has a large need for liquidity. In other words, sole proprietors should not be tying up the majority of their money in emerging market funds, hedge funds, small-cap growth stocks, mutual fund B-shares or variable annuities with steep surrender charges, etc. They should probably not even tie up too much capital in long-term bonds that are tough to exit at a fair price when interest rates are rising. Short-term debt securities will provide a regular, even if small, stream of interest and a stable principal, which will help the sole proprietor deal with seasonal slowdowns, industry slumps, leaky roofs, etc. Depending on their risk tolerance, maybe they could invest 70–80% of their money in debt securities with 2-year and shorter maturities, with 20–30% in large-cap value or large-cap growth stocks. That way, as their liquidity needs are being met, their capital also has a chance of growing over the long term, which could come in very handy when they want to expand or retire. Not that they shouldn't have retirement accounts for the latter purpose, which may well be handled quite differently from the funds we've been discussing. But more on that later.

PARTNERSHIPS

As Robert Kiyosaki explains in his book entitled *Cashflow Quadrant: Rich Dad's Guide to Financial Freedom*, there is a big difference between being a self-employed professional and owning a business. Many business owners are really just cantankerous codgers who can't take helpful suggestions, let alone criticism or orders, from other people. So they "go into business for themselves" and run everything as a sole proprietorship in which they control every aspect and answer to no one. We just looked at some pros and cons of that business structure.

Another approach is to take on a partner—maybe several partners. What we're talking about here, of course, is a partnership. In a partnership, the income and expenses of the business flow through directly to the owners. The business entity itself, in other words, is not taxed. The percentage of profits and losses flowing through to each of the owners is stated in the partnership agreement. Does the partnership create a separate entity that shields the owners from liabilities of the business? Well, yes. No. Maybe.

General Partnership

The main difference between general and limited partnerships has to do with liability. In a **general partnership**, two or more persons own the business jointly and are still subject to creditors and lawsuits personally. Unless otherwise stated in the agreement, the general partners control the business jointly, equally, with one vote each. Therefore, if Moe, Larry, and Curly want to open a restaurant and maintain 33.3% ownership each, a general partnership may be the way to go. Of course, all three are personally liable should Curly spill hot soup on a customer as a result of temporary blindness induced by a poke in the eye from Moe or Larry.

Basically, a general partnership is like a sole proprietorship with more than one owner. The owners agree to be in business together. They do not shield themselves personally from debts or liabilities of the business. But the income and expenses do flow through directly to the partners rather than being taxable to the business, and there are more people to share the good and the bad times with.

Limited Partnership

To form a **limited partnership**, there still has to be at least one **general partner**, who, as we just saw, has personal liability for debts and lawsuits against the business. But a limited partnership then has **limited partners** who maintain limited liability status, meaning they can only lose what they invest into the business. By "invest into the business," I mean the money they put in as well as any debts that they personally guarantee. A debt that a limited partner signs his name to may be called a **recourse note** on the exam, meaning that creditors have legal recourse, or the ability to come after him for the amount he guaranteed personally. A **non-recourse note**, then, would mean that the creditors have no recourse to collect this debt out of the investor's personal assets. The exam might say that a limited partner's cost basis "equals the capital he contributes initially plus the capital he agrees to contribute later." The exam might say a lot of things.

A limited partner is very interested in maintaining his/her/its/their limited liability status. To maintain the shield of protection, one thing that limited partners must do is stay the heck out of day-to-day management decisions. So, if the exam asks if limited partners should be making regular management decisions, the answer is no. Nevertheless, the LPs do get to vote on the big issues

of the partnership through something the exam might call “partnership democracy.” Partnership democracy would be used to allow the LPs to have a voice on a limited number of items, such as:

- Dissolving the partnership
- Suing the GP for negligence, breach of fiduciary duty, and other major irritations
- Inspecting certain records

The LPs can get involved with the above without jeopardizing their limited liability status, but not much else. When you’re an LP, it’s generally best to lay low.

The General Partner has a “fiduciary relationship” to the LPs, which means that the GP must put the LPs’ needs first. In legal terms, the GP’s fiduciary duty is “two-pronged,” meaning he has a duty of loyalty and a duty of good faith. His duty of loyalty means he can’t compete with the partnership. His duty of good faith means he has to do whatever he possibly can to run the business successfully and in accordance with the LPs’ best interests. The GP can end up getting sued by the LPs if it becomes clear that he is not meeting his duty to the limited partners, through negligence or even outright fraud. If the GP is a lousy businessman who is really just using the partnership as a front for a bunch of personal expenses or gambling activities, that is not going to sit well with the LPs. Or the courts, now that I think about it.

Since the GP has unlimited liability, the general partner is often a corporation rather than a natural person (human being). The corporate structure, as we’ll see, provides a layer of protection that would be totally lacking otherwise. Finally, when the limited partnership is liquidated, the senior creditors are paid first, then the unsecured creditors. The next priority is the limited partners, with the general partner last in line. If someone ever asks if you want to be a general partner, give it some hard thought.

The advantages of the limited partnership structure include:

- Flow-through of income and expenses directly to the partners
- Limited partners have limited liability

The disadvantages of the limited partnership structure include:

- General partner has unlimited liability
- Distribution of profits not as flexible as within an LLC

LLC (Limited Liability Company)

A **limited liability company (LLC)** is a type of business ownership combining several features of the corporate and the partnership structures. Although it combines features of the corporation and the partnership in a manner most curious, the limited liability company is, technically speaking, *neither* a corporation *nor* a partnership. Because the LLC is neither a corporation nor a partnership, the owners are neither shareholders nor partners. They are, instead, called “members.” In a little while, we will see that the S-Corp is limited to 100 shareholders, but the LLC has no limit on the number of members, who can be individuals, corporations, or *other LLCs*. The owners and any officers and directors are personally protected from the liabilities of the company, including being sued for their own negligence in operating the business, which is nice. Anyway, advantages of setting up an LLC include:

- Limited liability
- More flexible profit distributions (compared to most partnerships)
- No minutes (meetings not required, as opposed to corporations)
- Avoids double taxation of income

The exam may just bring up the fact that to be structured as an LLC rather than a corporation, the LLC needs to avoid two of four corporate attributes. Two of four. Remember that. That means that it needs to avoid two of the following characteristics associated with corporations:

- Perpetual life
- Centralized management
- Limited liability
- Freely transferable assets

It's almost impossible to avoid the centralized management, since the GP runs the business while the LPs put up and shut up. It's also tough to avoid limited liability as a, you know, limited liability company. Better go with the other two, then. So, how do they avoid the perpetual life and freely transferable assets associated with corporations? Ah. Well, unlike a corporation, an LLC has a limited life. For example, when the LLC is set up, perhaps it has a stated term of 30 years, after which it has to get dismantled. Regarding the assets and their transfer, the members have to agree that they won't sell their interests except according to a certain strict set of rules. For example, if you want to sell your interest to a stranger, the other members might have the right to buy the interest first to prevent that from happening, because who wants to suddenly be in business with a stranger? (Not that you should necessarily care, but such an agreement or right might be known as a "right of first refusal.") Without such a rule, if one of the members got himself into debt, the other members might discover they were in business suddenly with the guy's bookie, who wanted to collect the debt through the seized profit interest in his hand. Though, come to think of it, much to the bookie's frustration, the other members could vote *not* to distribute profits, and thereby thwart his evil plans. Though should they resolve the issue in such a manner, they might want to turn the car on in the morning by remote control for a few months.

In any case, the disadvantages of setting up an LLC include:

- Limited life
- Harder to attract financing (creditors don't like the idea explained above)
- More complexity than sole proprietorship (paperwork)

To set up a limited liability company, the business would file its articles of organization with the Secretary of State (not the one in D.C.) and pay the filing fees. The owners would also typically draft and sign an operating agreement. Similar to corporate bylaws or partnership agreements, these operating agreements spell out important points about ownership, responsibilities, and the distribution of profits.

S-Corps

A very popular form of business ownership is the **S-corp**. The S-corporation is a separate legal entity, so it offers some protection against debts and lawsuits compared to running the business as

a sole proprietor. The income and expenses pass directly to the owners, so it's like a partnership or limited liability company in that sense. In other words, it avoids being taxed as a business entity, even as it provides that separate legal structure known as a corporation. The advantages of using the S-corp structure include:

- No corporate tax (the entity is not taxed itself)
- Liability protection (compared to sole proprietor)
- Write-offs (early losses can offset personal income of the owners)

Of course, there are also disadvantages to the S-corp, including:

- One class of stock
- 100 shareholders maximum
- Corporate meetings required

If your business is hoping to attract venture capital, the VC firms will not like the S-corp structure with its direct flow-through of income and expenses and the limit of 100 shareholders. Also, all stock has equal voting rights and claims on profits, tying the hands of the financiers. And, even if it is a good idea, many business owners hate having to hold an annual meeting where they have to talk like Thomas Jefferson and write down the minutes to the most boring two and a half hours this side of C-SPAN.

Oh well. If you want to create a business structure that offers some protection against debts and lawsuits and still avoid the double taxation of income, the S-corp is an attractive option. More details on S-corps include:

- The corporation can have no more than 100 shareholders with a husband and wife counting as one shareholder.
- Shareholders can be individuals, estates, and certain trusts.
- Shareholders must be American residents.
- The S-corp must be a domestic company in any state.

C-Corps

The **C-corporation** is the traditional corporate structure. When we were talking about common stock in General Electric, Microsoft, Oracle, etc., we were talking about C-corps. In other words, since Microsoft has over 10 billion shares outstanding, it would be difficult to also be an S-corp, with its limit of 100 shareholders. This means that Microsoft is a separate legal entity that is taxed as a corporation—the profits do not flow directly through to large shareholders like Mr. Gates or even small shareholders like me. The corporation gets taxed on all those billions of dollars it makes year after year. Then, when the shareholders receive dividends on the stock, they are also taxed on that income.

The by-laws of the corporation and the corporate charter govern the operation of the corporation. A broker-dealer or adviser would look at the corporate resolution to see who has the authority to place trades and/or withdraw cash and securities. When opening an account for a corporation, the broker-dealer or adviser would get the officers who are authorized to transact business on behalf of the corporation to sign a “certificate of incumbency,” which the firm keeps on file.