1. Introduction

The financial decisions of a business enterprise must be made with some objective in mind -- otherwise it's like shooting an arrow without a target. This applies whether the decision is an investment decision (e.g., buying equipment), or a financing decision (e.g., issuing bonds). In this reading, we first look at the different forms of business enterprise; we look at these forms in order to better understand the context in which decisions are made. Following the discussion of the forms of business, we focus on the objective of financial management: the maximization of owners' wealth. We then take a look at the agency relationship -- when managers represent owners' interests -- and some of the problems this agency relationship may create.

There are three basic forms of business:

1. Sole proprietorship
2. Partnership
3. Corporation

In the U.S., the most common form of business is the sole proprietorship. However, in terms of the business revenue, the corporate form is dominant in the U.S. We will look at each of these three forms of business and then take a look at hybrid forms that borrow features from one or more of these basic forms of business.

2. The sole proprietorship

A sole proprietorship is a business enterprise owned by one person. It is the simplest and most common form of business enterprise because it is a business owned and controlled by one person -- the proprietor. The proprietor receives all income from the business and alone decides whether to reinvest the profits back into the business or use them for personal expenses.
If more funds are needed to operate or expand the business than are generated by business operations, the owner either contributes his or her personal assets to the business or borrows. For most sole proprietorships, local banks represent the primary source of borrowed funds. However, there is a limit to how much banks will lend proprietorships, most of which are relatively small businesses.

A proprietor is liable for all the debts of the business; in fact, it is the proprietor who incurs the debts of the business. If there are insufficient business assets to pay a business debt, the proprietor must pay the debt out of personal assets.

For tax purposes, the sole proprietor reports income from the business on his or her personal income tax return. Business income is treated as the proprietor's personal income. Therefore, business income is taxed once -- as the proprietor's individual taxable income.

Because the proprietorship is dependent on the single owner, the life of a sole proprietorship ends with the life of the proprietor, though the assets of the business may pass to the proprietor's heirs. The assets may also be sold to some other firm, at which time the sole proprietorship ceases to exist.

The basic distinguishing features of a sole proprietorship are:

- Financing of the business enterprise is from proprietor's own funds and from bank borrowings.
- The proprietor is liable for debts of the business.
- Income of business is taxed as income of the proprietor.
- Life of the business ends with the life of the proprietor.

There are a number of advantages and disadvantages of a sole proprietorship as a form of doing business. Advantages include the following:

1. Decision-making is simple (because the proprietor controls decisions).
2. The owner receives all income from business.
3. Income is taxed at only one level (that of the owner).

But the sole proprietorship form of business is not without its disadvantages. Disadvantages include:

1. Unlimited liability -- the owner is liable for all debts of the business.
2. Limited life of the proprietorship -- the life is limited by the life of the owner.
3. The business has limited access to additional funds. Most of the fund are from the proprietor's own assets or from lending arrangement with local banks.

3. Partnership

A partnership is a business enterprise owned by two or more persons who share the income and liability of the business. There are different types of partnerships, including:

- General partnership
- Limited partnership
- Master limited partnership
These different types of partnerships differ in terms of the liability and control of the partners.

A **general partnership** is a partnership in which each partner is liable for the debts of the business; each partner referred to as a general partner. The owners (i.e., the partners) share in the management of the business and share in the profits and losses of the business according to the terms of the partnership agreement. In a general partnership, each partner is liable for the debts of the partnership under the legal concept of **joint and several liabilities**. Joint and several liability means that a creditor can sue one or more of the partners separately or all of them together.

The life of the partnership may be limited by agreement or by life of partners, requiring a reformulation of the partnership as partners exit and enter the partnership. Further, ownership of a partnership interest cannot be freely transferred; this causes some problems in cases of a partner wanting to leave or in the event of the death of a partner (because the partnership share cannot be inherited).

The partnership can raise funds from either partner contributions or from borrowing from local banks, though these sources may be quite limiting for a growing partnership. Because the partners own 100 percent of the ownership, additional ownership interests cannot be sold. The importance of this limitation is that a large, growing partnership may be constrained by its limited sources of financing.

The income of partnership is taxed as income of partner (in portions agreed upon in partnership agreement), flowing directly to the taxable income of the partner. Like the sole proprietorship, the business income of a partnership is taxed only once -- as the individual owners' income.

There are a number of advantages of the partnership form of business. Advantages include:

1. The general partners are decision-makers.
2. The owners (the partners) divide income according to partnership agreement.
3. Income is taxed once.

Disadvantages include:

1. Unlimited liability for each partner.
2. A limited life of partnership.
3. Limited access to additional funds.

A **limited partnership** is a partnership in which there are both general partners -- who typically are also the managers of the partnership -- and limited partners -- who have limited liability but also limited say in the decision-making of the partnership (which is why limited partners are often referred to as "silent partners").

A **master limited partnership** is a limited partnership in which limited liability ownership units are publicly traded. The ownership interests, which represent a specified ownership percentage, are traded in much the same way as the shares of a corporation. One difference, however, is that a corporation can raise new capital by issuing new ownership interests, increasing the number of shares of stock (but diluting existing shares), whereas a master limited partnership cannot. It is not possible to sell more than a 100 percent interest in the partnership, yet it is possible to sell additional shares of stock.

### Examples of master limited partnerships

- Alliance Resource Partners, LP
- AmeriGas Partners, LP
- Inergy, LP
- Magellan Midstream Partners, LP
- Pacific Energy Partners, LP
- Sonoco Logistics, LP
- TEPPCO, LP
4. The corporate form of business

A corporation is a business entity created by law that is capable of entering into contracts, incurring liabilities and carry out business. The corporation comes into being when the state grants a charter. A charter is granted when the firm files the articles of incorporation (a description of the business and the rights and responsibilities of its owners), which includes the bylaws (rules of governance), and forms the board of directors (the representatives of the owners). The board of directors may consist of both inside directors (employees of the corporation) and outside directors (non-employees). Within the board of directors of a company are several committees, including the audit committee and the compensation committee. The Sarbanes-Oxley Act of 2002 imposes a requirement that the audit committee, which is responsible for the appointment, oversight, and compensation of the independent public accounting firm that audits the company’s financial statements, be comprised solely of independent members of the board of directors.\(^1\)

In effect, the state corporate laws serve as the boundary for the articles of incorporation. However, being incorporated in a certain state does not mean that the firm must do business there -- or even relocate its headquarters. The majority of large U.S. corporations are incorporated in the state of Delaware, primarily because of its "corporate-friendly" and court-tested laws.

Unlike the sole proprietorship and partnership, the corporation is a taxable entity. It files its own income tax return and pays taxes on its income. That income is determined according to special provisions of the federal and state tax codes and is subject to a separate schedule of corporate tax rates.

If the board of directors decides to distribute cash to the owners, that money is paid out of income left over after the corporate income tax has been paid. The amount of the cash payment, or dividend, must then also be included in the taxable income of the owners. Therefore, a portion of the corporation's income (i.e., the portion paid out to owners) is subject to double taxation: once as corporate income and once as individual owner's income. The dividend declared by the directors of a corporation is distributed to owners in proportion to the numbers of shares of ownership they hold. If owner A has twice as many shares as owner B, he or she will receive twice as much money.

The ownership interest of a corporation (also referred to as equity), can be owned by a very few investors (i.e., a closely-held corporation) or publicly traded (i.e., a public corporation or publicly-held corporation). In other words, a corporation may be a privately-held corporation or a publicly-traded corporation. Examples of large, well-known private corporations include Mars, Publix, and Cargill. A corporation can raise funds by borrowing or by issuing additional ownership interests.

Public corporations must register with the Securities and Exchange Commission (SEC), describing their business, filing financial statements, and describing any security issuance. The Securities and Exchange Act of 1934 requires corporations in interstate commerce (1) whose stock is listed on national exchanges, or (2) who have over 500 shareholders and over $1,000,000 in assets, to file an initial registration statement with the Securities and Exchange Commission (SEC), a federal agency created to oversee the enforcement of United States (U.S.) securities laws. This statement provides information regarding the nature of the business, the debt and stock of the corporation, the officers

\(^1\) Section 301, Sarbanes-Oxley Act of 2002.
and directors, any owners of more than 10 percent of the stock, financial statements, articles of incorporation, by-laws, and other items.

Each corporation required to file this registration statement must also make periodic reports to the SEC, updating the information in the registration statement, and provide annual and quarterly financial statements. For example, the annual filing, referred to as a 10-K statement, provides financial statements (e.g., income statement, balance sheet) as well as management’s discussion and analysis. Both the registration statement and the updating information are made available to the public -- and particularly the shareholders (and potential shareholders) -- following review by the SEC.

There are a number of advantages and disadvantages of the corporate form of business. Advantages include:

1. Limited liability - the most an owner can lose is the original investment in the company.
2. The business enterprise has a life in perpetuity -- out living its owners.
3. The corporation has access to additional funds through the sale of new share of stock.
4. Income is distributed according to proportionate ownership.

Disadvantages include:

1. The separation of ownership and decision-making.
2. Double taxation on income -- income is taxed at both the corporate level and the individual owner level when dividends are paid out.

**Example: Double Taxation**

Suppose a corporation has taxable income of $100,000 and is taxed at a flat rate of 40 percent of taxable income. Suppose further that the corporation pays all of its after-tax income to its shareholders whose income is taxed at an average rate of 30 percent.

- The corporation pays $100,000 x 0.40 = $40,000 in taxes and pays the remainder, $100,000 - 40,000 = $60,000, to shareholders.
- The shareholders then must pay taxes of $60,000 x 0.30 = $18,000.
- Out of the $100,000 of income, shareholders are left with only $60,000 - 18,000 = $42,000.
- In effect, the shareholders' income has been taxed at the rate of 58 percent. In other words, for each dollar of income, 58¢ is paid in taxes.

![Figure 1. Breakdown of $100,000 of corporate income if the corporate tax is 40 percent and the tax on shareholders' income is 30 percent.](image)
5. Hybrids

There are a number of other forms of business enterprise that are hybrids of the three basic forms. The hybrid forms that we will discuss are the professional corporation, the joint venture, and the limited liability company.

A **professional corporation** is a corporation (for tax purposes) in which owners have unlimited liability. The businesses that are likely to form such corporations are those that provide services and require state licensing. These businesses include public accountants, physicians, surgeons, architects, and attorneys, since it is generally felt that it is in the public interest to hold such professionals responsible for the liabilities of their business.

A **joint venture** is a partnership or a corporation formed for a specific business operation. For tax and other legal purposes, a joint venture partnership is treated as a partnership and a joint venture corporation is treated as a corporation.

U.S. corporations have entered into joint ventures with foreign corporations, enhancing participation and competition in the global marketplace. Joint ventures are an easy way of entering a foreign market and of gaining an advantage in a domestic market. For example, General Electric's energy subsidiary, GE Energy, formed a joint venture partnership with Shanghai Xin Hua Control Technology in 2005, giving General Electric a solid footing in the power generation business in China.

Joint ventures are becoming increasingly popular as a way of doing business. Participants -- whether individuals, partnerships, or corporations -- get together to exploit a specific business opportunity. Afterward, the venture can be dissolved. Recent alliances among communication and entertainment firms have sparked thought about what the future form of doing business will be. Some believe that what lies ahead is a virtual enterprise -- a temporary alliance without all the bureaucracy of the typical corporation -- that can move quickly and decisively to take advantage of profitable business opportunities.

More recently, companies are using a hybrid form the **limited liability company (LLC)**, which combines the best features of a partnership and a corporation. In 1977, Wyoming became the first state to permit LLCs. In 1988 the Internal Revenue Service ruled that the LLC be treated as a partnership for tax purposes, while its owners are not liable for its debts. Since this ruling, all fifty states have passed legislation permitting limited liability companies.

Though state laws vary slightly, in general, the owners of the LLC have limited liability. The IRS considers the LLC to be taxed as a partnership if the company has no more than two of the following characteristics:

1. Limited liability.
2. Centralized management.
3. Free transferability of ownership interests.

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2 Internal Revenue Service Ruling 88-76.
If the company has more than two of these, it will be treated as a corporation for tax purposes, subjecting the income to taxation at both the company level and the owners'.

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