

## Chapter 6- the Forms and Taxation of Business

The Law recognizes three forms of business:

1. A sole proprietorship
2. Various types of partnerships
3. Various types of corporations

They are all different because of:

1. **Liability**: an obligation of an individual or organization that comes about because of a transaction or event; debts
2. Taxes: amounts governments levy on individuals or organizations
  - a. Taxes that governments gather for the **goods and services** that governments provide society
  - b. Taxes that the government uses to **motivate behavior**
  - c. Taxable income: net income before taxes

Businesses want to minimize or postpone taxes to maximize

Other ways to choose what forms of business to go into:

1. Ease and cost of starting and ending a business
2. Ability to own and manage
3. Selling their business in the future

Difference between public and private market; NY Stock Exchange= public market

**Sole proprietorship**: when one person owns and controls the business

- Most numerous form of US business
- Easiest to create and end
- No legal form of action to start or end business
- The law cant recognize the difference between the business and the owner in sole proprietorship
- The owner and the business own assets and owes money
- Unlimited liability= bad
- Single taxation= good; tax is paid by owner NOT the business

**Partnerships**: business has multiple owners (general owners) where their responsibilities are legally documented in a partnership agreement

- Easy to start and end and they have single taxation
- Unlimited liability; **jointly liable** for debts
- **Limited Liability Partnership**: just like a regular general partnership with the exception that some partners can be designated as **limited partners**
  - o **Limited partner**: puts money into the partnership and receives a profit but cannot actively manage the partnership
- Most are not **publicly traded**
- **Master Limited Partnership**: limited partnership that can be traded in a public market

**Corporations:** a group of owners that have created a new entity or body in the sight of the law; viewed by the law as an entity that is DIFFERENT from its owners; chartered by a state government

- This charter makes the corporation able to enter into contracts, own property, incur liabilities, and earn net income or loss in and of itself
- Owner by shares to own part of company; owners own the corporation
- **Limited liability:** the most an owner can lose is its own share
- A business is taxed on its taxable income
- **Dividend:** distributed income to owners
- Income is taxed, and then the dividend is taxed; **double taxation**
- Most corporations are **conventional corporations**
  - o Permits small businesses to incorporate: limit liability but be taxed as a partnership
  - o **S Corporation:**
    - 100 stockholders
    - stockholders must be individuals or estates
    - permanent residents of USA
    - one type/class of stockholders
    - 75% of income active
    - lawyer or doctor
- Taxes:
  - o Impact business value by affecting the **amount and timing** of the after-tax net income owners receive
  - o Three of the most common forms of tax are:
    - **Income tax:** taxes governments charge on a business's net income (**taxable income**)
      - **Flat tax:** tax rate doesn't vary
      - **Graduated tax rate:** tax rate varies depending on the level of income; **progressive tax** is when the tax rate goes up as income goes up; USA has progressive tax
      - **Average tax rate:** total taxes/ total taxable income
      - **Marginal tax rate:** tax rate the business will pay on the next dollar of taxable income
    - **Excise tax:** taxes the governments charge on the manufacture, sale, or consumption of a product
      - **Sales tax:** excise tax on the purchase, sale, and consumption of a product
      - **Value-added tax:** tax paid by the customer; as the product progresses through the value chain its costs are increased in value; taxed based on the value added
    - **Property tax:** tax on value of property; can include value of buildings, equipment, and intellectual property (patents).
  - o Amount of tax= amount of taxable event \*tax rate
- **How do businesses deal with taxes?**

- o Understand the tax law and always comply
- o Taxes impact the value of business so they need to conduct tax planning and strategy to minimize their taxes
- Mergers and Acquisitions: when one company buys another company or their assets (merger=company; acquisition= assets)
  - o Pay for this with cash, debt, or stock
  - o **Leveraged buyout**: when a company buys another company using high levels of debt
  - o **Stock Swap**: when a company buys another company with stock; uses their own stock to pay for the stock of the purchased company
  - o **Subsidiary**: company bought remains a separate entity; but their parent company still owns it
  - o **Wholly Owned**: buys all of the other company
    - *Control usually means owning the majority*
  - o **Consolidated**: combined with the parent company
  - o **Vertical integration**: purchasing a business in the same value chain; Pepsi once owned Taco Bell= sell Pepsi products at Taco Bell
  - o **Horizontal Integration**: purchasing a business that is a competitor or similar company; Sears bought Kmart
  - o **Conglomeration**: combination of unrelated business to reduce risk; don't put all your eggs in one basket
- Joint Venture: temporary partnership created for a single enterprise or transaction
- Licensing: the right to use **intellectual property= intangible assets** for a fee; copyrights, trademarks, and patents
- Franchising: when a business sells the right to use its name, process, and products to another business
  - o **Franchiser agreement**: specific rights and responsibilities
- Cooperation: form either a partnership or corporation for the benefit of the customer
  - o Bond together so that they're big enough to buy products at a lower price, to get better service, and lower risk