

SETTING UP OF BUSINESS ENTITIES & CLOSURE

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SETTING UP BUSINESS ENTITIES AND CLOSURE

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PART – A



CHAPTER - 1

CHOICE OF BUSINESS ORGANIZATION

❖ INTRODUCTION

Business organisation refers to all necessary arrangements required to conduct a business in an optimized manner. It refers to all those steps that need to be undertaken for establishing and maintaining relationship between men, material, and machinery to carry on the business efficiently for earning profits.

❖ TYPES OF BUSINESS ENTITY

1. Sole proprietorship
2. Partnership
3. Limited liability partnership
4. Company
5. Hindu undivided family
6. Co-operative societies
7. Branch office

❖ TYPES OF COMPANY

1. Guarantee Company
2. Public Limited Company
3. Private Limited Company
4. One Person Company
5. Unlimited Company

Essentially, companies could be either private limited or public limited companies, public limited companies could be unlisted or listed. Each entity must sit down and carefully consider all the advantages and disadvantages of each type of entity before choosing one of the form of business entity which suited best to the nature and size of the business which the entrepreneur / business owner desires to undertake.

❖ FACTORS GOVERNING THE DECISIONS FOR SUITABLE FORM OF ORGANISATIONS

For a new or proposed business, the selection of a suitable form of a business organisation is generally governed by the following factors-

1. Nature of business activity

This is an important factor having a direct bearing on the choice of a form of ownership. In small trading businesses, professions, and rendering of personal services, sole-proprietorship is the perfect form of organisation.

Partnership is also advantageous in case of manufacturing activities on a modest scale. The finance, trading and real estate industries (on a smaller scale) seem to be suited to partnership form of organisation.

Similarly, the business lines such as carrying on large chain stores, multiple shops, super bazaars, engineering industrial activities with high capital and working capital requirements and software industrial activities are generally in the form of companies.

Where the persons intending to start a business wish to launch a business organisation clothed with a legal entity and in corporate form with a feature of having their sole ownership and control thereon, they may decide to form a One-Person Company (OPC). OPC is a new concept in India and hybrid of Sole-Proprietor and Company form of business. The concept opens spectacular possibilities for sole proprietors and entrepreneurs as, such companies retain the character of a Sole Proprietorship, provides limited liability feature to the sole proprietor and is clothed with a legal entity distinct from its owner.

An alternative form of organisation where two or more persons are involved in starting the business organisation is the Limited Liability Partnership ('LLP') under the Limited Liability Partnership Act, 2008. Such entities have also gained popularity nowadays. A major advantage of such an entity is that the liabilities(if any), of the LLP lies with the entity and does not fall on the individual partners unlike the partnership form of business organisation under the Indian Partnership Act, 1932, where the joint and several liabilities of the partner(s) is one of the features. In an LLP form, the liability of the Partner is limited to the extent of his contribution towards the LLP, except in case of intentional fraud or wrongful act of omission or commission by the partner himself. What is at stake for the partner is what he has put into the business along with any personal guarantees he would have furnished. However, such forms of business organisation are suitable generally in the service industry and where there is no dependence on large amounts of financing from outside sources. A One-Person Company (OPC), LLP and limited company exist as a separate business entity in the eyes of law and this creates a wall between the personal assets of the investor and that of the business. Thus, these forms of business organisations the personal property of the owner(s) is protected and this gives the owner(s) the ability to build the business credit, get loans and raise capital.

2. SCALE OF OPERATIONS

Small	Sole proprietorship or OPC
Medium	Partnership or LLP
Large	Company

The second factor that affects the form of business organisation is the scale of operations. If the scale of operations of business activities is small, sole proprietorship or a One Person Company (OPC) is suitable; if the scale of operations is modest — neither too small nor too large — partnership or limited liability partnership (LLP) is preferable; whereas, in case of large scale of operations, the company form is advantageous.

3. CAPITAL REQUIREMENTS

Capital is one of the most crucial factors affecting the choice of a particular form of ownership organisation. Requirement of capital is closely related to the type of business and scale of operations. Enterprises requiring heavy investment (like iron and steel plants, large scale infrastructure projects, etc.) should be organised as companies. Depending on the capital required, they can be set up as public companies and in some cases, may be in the

form of listed companies by raising money from the public and being listed on the stock exchanges.

Enterprises requiring small investment (like retail business stores, personal service enterprises, etc.) can be best organised as sole proprietorships or even as Partnerships. Apart from the initial capital required to start a business, the future capital requirements—to meet modernisation, expansion, and diversification plans — also affect the choice of form of organisation.

In sole proprietorship, the owner may raise additional capital by borrowing, by purchasing on credit, and by investing additional amounts himself. Banks and suppliers, however, will look closely at the proprietor's individual financial resources before sanctioning any loans or advances.

Partnerships can often raise funds with greater ease, since the resources and credit of all partners are combined in a single enterprise.

4. MANAGERIAL ABILITY

It is difficult for a sole proprietor to have expertise in all functional areas of business. Further, the size of the business may not permit engagement of professional management. In other forms of organizations like partnership and company, there is division of work among the partners which allows the partners to specialize in specific areas, leading to better outputs and decision making. However, this may sometimes lead to conflicts due to differences of opinion.

Company form of organization is a better alternative if the operations are far flung, complex in nature and require professional management at various levels.

5. DEGREE OF CONTROL AND MANAGEMENT

The degree of control and management that an entrepreneur desires to have over business affects the choice of form of organisation.

In sole proprietorship and OPC, ownership, management, and control in the hands of an entrepreneur, he has complete control over his business.

In partnership, management and control of business is jointly shared by the partners and their specific rights, duties and responsibilities would be documented through incorporating various clauses in this regard in the partnership deed.

In a company, however, there is separation in ownership and management, the management and control of the company business is entrusted to the Board, who are generally the elected representatives of shareholders.

6. DIVISION OF PROFIT

Profit is the guiding force of private business and it has a tremendous influence on the selection of a particular form of business organisation. An entrepreneur desiring to pocket all the profits of business will naturally prefer sole proprietorship. Of course, in sole

proprietorship, the personal liability is also unlimited. But, if he is willing to share the profits, partnership form of organisation would be preferred.

In company organisation, however, the profits (whenever the Board of Directors decides) are distributed among shareholders in proportion to their shareholding, but the liability of the shareholders is also limited. The rate at which dividend is to be distributed is decided by the Board, though approved by the shareholders.

Companies may also reward shareholders by issue of bonus shares. In case of listed companies, the equity shares are tradable on the stock exchanges, enabling the shareholders to exit the company at any time as per their own discretion.

7. DEGREE OF RISK AND LIABILITY

The size of risk and the willingness of owners to bear it, is an important consideration in the selection of a form of business organisation. The amount of risk involved in a business depends, among other factors like, on the nature and size of business. Smaller the size of business, smaller the amount of risk.

Thus, a sole proprietary business carries small amount of risk with it as compared to partnership or company. However, the sole proprietor is personally liable for all the debts of the business to the extent of his entire property. Likewise, in partnership, partners are individually and jointly responsible for the liabilities of the partnership firm.

Companies and LLPs have a real advantage, as far as the risk is concerned, over the other forms of business organisation. Creditors can force payment of their claims only to the limit of the company's and LLPs assets. Thus, while a shareholder/member/partner may lose the entire money he puts into or agreed to put into the company and LLP, he cannot be forced to contribute additional funds out of his own pocket to satisfy the business debts of the company and LLP.

8. TAX IMPLICATION

In the choice of the form of business organisation, tax implication plays an important factor. In smaller entities, such as sole proprietorship or partnership, tax liability is dependent on the extent of profits.

However, the liability of the owner(s) is unlimited. In case of companies or LLPs the liability of shareholders is limited to the value of shares they have purchased. In case of companies or LLPs, tax liability could be higher.

9. TRANSFERABILITY OF OWNERSHIP

Sole proprietorship, being a one-person entity does not lend itself to transferability of ownership as the owner himself enjoys the profits and suffers the losses in his business. Partnership form of organisation is one where two or more partners share the profits and/or losses in the agreed proportion. If a partner exits, the partnership, may decide to induct a new partner with benefits of ownership and share of profits or losses.

In the company form of organisation, transfer of ownership is possible by transfer of shareholding by any person or group of persons in favour of another person or group of persons.

10. MANAGERIAL NEEDS

Managerial and administrative requirements also affect the decision about the form of organisation. When the concern is small and it caters to local needs only then one person will be enough to manage the business.

Sole – proprietorship form of organisation will be suitable for such a business. If business caters to more areas, then more persons will be needed to look after various business functions in various areas. When a business is run on a large – scale basis, it will require the services of specialists to manage various departments. The company form of organisation will be suitable for such concerns.

11. SECRECY

Secrecy is of supreme importance, particularly in small business concerns. Accordingly, the entrepreneur would select the sole proprietorship for that reason. In case, he has partners, he will have to carefully weigh whether other partners will be able to maintain the secrecy. He will have to exercise great care in taking partners. In case of a company, secrecy may be restricted to the manufacturing process or the manner in which business is conducted. However, certain aspects of their business such as their board of directors, shareholding, financial statements and other information which are statutorily required to be placed in public domain are accessible to any person

THE END



ABOUT THE AUTHOR

Prof. JIMIT MARADIA is a Law graduate & Company Secretary. He has been associated as a Legal Advisor for various companies and worked for various legal firms. His experience ranges in different fields like Arbitration, Non Compliance matters, Labour Law matters, Corporate & Matrimonial matters.

He is teaching Law subjects to students of CS, CA, CMA & LLB. He is also teaching Law at different Law colleges as a visiting faculty. He is currently teaching at ACE TUTORIALS (Mumbai) for CS course.

Prof. BHADRESH GOHEL has been practising for Company Law and Compliance matters. He has been associated as a Legal Advisor for various companies. He is also a motivational speaker and conducting career guidance sessions to the aspiring students.

He is teaching Law subjects to students of CS, CA. He is currently teaching at ACE TUTORIALS (Mumbai) for CS course.



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