

## CHAPTER 4. THE LEGAL FORM OF THE ORGANIZATION

### 4.1 INTRODUCTION

The form of the organization has two components: its legal form and its functional form or structure. While these two components are separate business decisions, there is a tendency for them to be related partially. As the business grows it will face important decisions pertaining to management and control, financing, personnel issues, and problems of liability. These decisions can affect both the legal and functional forms of the organization but the decision to structure its operations in a particular manner is a different decision compared to whether the firm should operate as a partnership, corporation, etc.

The legal form refers to the form of ownership of the organization as it is viewed by the legal and taxation authorities; for example, sole proprietorship, partnership, or corporation. The functional form refers to the organizational control structure and is often a primary issue in strategic planning because strategic planning may reposition or restructure the firm to achieve operational benefits. Organizational forms include departments, team approaches, and hybrid forms such as the matrix or modified-team organization. The functional form of the organization will be covered in greater depth in the next chapter, but it should be realized that decisions on these two forms are quite different and have different implications for the business.

The legal form of the organization results from state statutes and the tax code of the Internal Revenue Service. There are three basic types of legal organization for the practice of design: proprietorship, partnership, and professional corporation; but within these basic types there are a number of variations. These organizational forms are shown below:

- i. Sole proprietorship;
- ii. Partnership, limited partnership;
- iii. Profit corporation, professional corporation, subchapter-S corporation, non-profit corporation;
- iv. Joint venture;
- v. Unincorporated association, loose association, professional association.

The selection of the appropriate legal form of business requires a careful consideration of the following factors:

- a. The goals and objectives of the organization and its owners;
- b. The degree of control and responsibility required by the owners of the firm and the potential for agency problems if ownership and control are separated;
- c. An assessment of the business opportunities and requirements as to the duration of the organization, level of risk, potential for cash generation and losses, requirements for investment funds from internal and external parties, etc.;
- d. An assessment of the business environment, including legal and taxation considerations as they affect risk exposure, profitability, and the individuals associated with the business.

Each of these organizational forms has specific advantages and disadvantages and, as a result, the legal form of the business may change as the firm evolves and particular advantages and disadvantages become more important. There is a tendency for firms to evolve from sole proprietorships to partnerships to corporations as they grow in size and complexity, but this is not necessary; rather, the different legal forms are able to solve particular problems and take advantage of opportunities in different ways so that a specific form is better suited to the firm as it changes over time.

One of the primary issues in selecting a legal form for the business is to limit the liability of the owner(s). There are three types of liability with which an owner of a firm should be concerned. Professional liability arises directly from the operation of the business in providing professional services to clients (whether for compensation or for free). Professional liability cannot be reduced by the legal form of the organization; a design professional such as an architect or industrial designer always will remain liable for his or her professional services within the constraints of contract and tort law (negligence, etc.).

Business liability is a different matter. The debts incurred by the business, if formed as a legal corporation, usually can be limited to the assets of the corporation unless the owner(s) has guaranteed the debt using his or her own personal wealth as collateral or if the corporation is established with the purpose of defrauding the firm's creditors. Similarly, third-party liability that results when an employee is injured at work or when a stranger is injured by falling down the steps of the firm's own office building, etc., is limited in amount by the assets which are owned by the corporation.

## **4.2 SOLE PROPRIETORSHIP**

The sole proprietorship is the simplest and one of the most frequently formed types of organization. For those professional disciplines that require registration, the practitioner must pass examinations etc. to be certified to practice, but once the individual is registered in the state in which he or she desires to practice all that must be done is to "hang out the shingle." There are no additional or special legal restrictions that apply solely to the sole proprietorship (beyond some requirements for registering fictitious names). The income of the business is taxed on the individual owner's tax return (IRS Form 1040). This means that every year all of the income and the legitimate expenses of the business are listed on the individual's tax return and are taxed at the individual's marginal tax rate in addition to any other income derived from alternative sources. The after-tax profits from the business belong to the owner and can be used for the purposes of investment or consumption as the owner desires. There is no legal requirement to register the business with any governing authority, and the owner has complete authority to operate the business subject to the legal constraints of criminal and civil law. There are no legal requirements to keep records of the business beyond those required for taxation purposes.

There are three primary disadvantages of the sole proprietorship:

- i. The owner has unlimited liability, both professionally and for the business.
- ii. The capital necessary to finance the business may be limited in amount and availability. Capital is provided by the owner or by borrowing from others, but lenders are unwilling to lend amounts greater than those which can be supported by the owner's personal wealth which is used as collateral for the loan.
- iii. The business is automatically terminated upon either the death of the owner or at the owner's discretion and may cause substantial problems for employees, suppliers, and clients. In the event of the death of the owner, operation of the firm may continue if a special provision has been made in the owner's will for the executor to take over until the business is transferred to its new owner (by sale or inheritance).

## **4.3 PARTNERSHIP**

A partnership is defined as a business association of two or more individuals who are co-owners of that business. The advantage of the partnership over the sole proprietorship is that the potential to increase the number of owners also increases the resources of the organization, such as the amount of capital available or by bringing together partners who have different capabilities (for example; design, management, production, etc.). There is no limit to the size of the partnership and it is easily formed at a minimal cost with differing degrees of formality, ranging from an informal oral agreement to a carefully drafted written partnership agreement filed with the applicable state authorities.

Provision is made for taxing the profits of the partnership in the Internal Revenue Code. All income from the partnership is divided according to the partnership agreement (or equally, unless otherwise stated) and "carried" to the individual partner's tax return (IRS Form 1040) where it is taxed at the individual's marginal tax rate. Losses from the business are also divided and are deducted from each partner's other taxable income (if it exists). It should be noted that all partnership income is taxed to the individual partner whether or not the income is actually distributed. This includes income that is reinvested in the partnership.

While it is not a separate legal entity, as is a corporation, the partnership is subject to legal requirements established in the Uniform Partnership Act (UPA). This act has been adopted by every state except Georgia and Louisiana and covers the rights and responsibilities of the partners to the extent that these issues have not been covered in the partnership agreement.

A written partnership agreement is not required (unless the life of the partnership will exceed one year) but it is recommended strongly since the agreement between, or among the partners is a binding contract. All parties to the contract should be fully aware of their rights, responsibilities, and obligations and a written agreement is the best way of doing this. It is also advisable for the agreement or articles of partnership to be prepared by an attorney who is experienced in such matters and for each partner to have his or her own attorney examine the document. The agreement should, as a minimum, cover the following issues:

- a. Identity of the business;
- b. Date of formation;
- c. Purpose of the partnership;
- d. Recognition of all partners by name and address;
- e. Location of business activities;
- f. Period of time that the partnership will be in effect;
- g. Capital or other contributions provided by each partner;
- h. Basis for distributing profits and losses;
- i. Provisions for withdrawal of profits and compensation of partners;
- j. Responsibilities and authority of all partners, including the rights to manage and conduct business (assumed equal unless otherwise agreed);
- k. Required accounting records that must be prepared and access of partners to same;
- l. Basis for dissolution and distribution of assets (including capital assets such as office equipment, clients, commissions, etc.) as well as documentation of previous projects;
- m. Methods of resolving disputes (arbitration, etc.);
- n. Special limitation on partners to prevent assumption of liabilities beyond the business of the partnership;
- o. Procedures in the event of the death or withdrawal of a partner and the means for protecting the surviving partners.

The method of management and control of the partnership should be established in the partnership agreement. Generally, a majority vote can decide most management/control issues although a unanimous vote must be taken before the partnership agreement can be changed to preserve the rights of minority interests. In some large partnerships, the operation of the firm may be more effective if control is delegated to a small number of partners who can decide most issues without seeking majority approval.

The key problem in the partnership form of organization is that of fiduciary responsibility. That is, each partner is required to act in good faith to every other partner, avoid conflicts of interest, account for other activities, and perform at an optimum level. Fiduciary duty is important because there generally is unlimited liability for individual partners (unless the firm is a limited partnership), and each partner is jointly and separately liable for the actions of other partners. This includes liability for both the professional activities of partners as well as for the operation of the business (for example, debts incurred either by the partnership or by individual partners in the course of the business of the partnership). This is covered in Section 9.1 of the UPA:

“Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he or she is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no authority.”

The fact that one partner can bind one or all of the other partners, even if he or she has only apparent authority, means that great care should be taken when forming a partnership, entering an existing firm, or elevating an associate to partnership status. As Sweet (1985) observed:

“... because of the vast range of authority given to the partners, both actual and apparent, and the fiduciary obligation owed by each partner to the other, the character and integrity of prospective partners are of great importance.”

The liability of the partnership's individual members for the debts of the partnership means that in the event of default the creditors of the firm can take the property of the partnership and, if still insufficient to cover the obligations, then look to the property of individual partners. If this is not enough to suggest that extreme caution should be used in selecting partners, consider the following:

- a. The creditors of an individual partner (for debts incurred outside the partnership) can obtain a court judgment and then satisfy that judgment by taking assets out of the individual partner's interest in the partnership (whether or not those assets were contributed by that individual).
- b. Although a partner generally will not be held responsible for the debts incurred by the partnership before he or she joined (or after he or she leaves) the partnership, there is enough uncertainty in the law to suggest that an entering partner determine what obligations already exist and that a departing partner inform all other parties with whom the partnership has dealt that he or she is no longer with the partnership.

There also may be a substantial problem when individual partners bring different abilities and resources to the firm. In addition to the obvious problems of under-performance, neglect, or even fraudulent activity, there are problems of determining the relative values of the partners' respective contributions. These problems give rise to costs of monitoring the other partners to ensure that each performs at an acceptable level. Ideally the partnership agreement will define carefully the permissible activities of partners both inside and outside the partnership. If the agreement does not cover the level of performance required, then partners will be assumed to devote their full energies to the business and, unless agreed upon otherwise, profits and losses will be shared equally, even if one or more of the partners has worked much less than the others.

The dissolution of the partnership can be brought on by a large number of events. Generally, if a partner leaves (or dies), the partnership ceases to exist. However, this does not mean the end of the business because the remaining partners can buy out the interest of the partnership. A common practice is for each partner to carry life insurance equal to the value of his or her interest, with the remaining partners named as beneficiaries to avoid placing financial pressure on the partnership if one of the partners dies.

There also may be problems of transferring ownership of a partnership share. For example, some agreements require that a partner not sell his/her interest to another party without the consent of the remaining partners because the potential for conflicts exists.

## **4.4 LIMITED PARTNERSHIP**

The limited partnership (and the use of associate partners in the partnership) can be used to restrict the liability of some partners for business obligations and liabilities. However, at least one of the partners must be a general partner who remains fully liable for the business. The liability of the limited partners is limited to the extent of their investments, while at the same time they are able to participate in the profits of the business. The limited partners are strictly investors and are restricted in their abilities to manage or control the partnership; this role falls to the general partner(s). This does not mean that the limited partner is a passive investor because all parties have the right to examine the records of the business or to force the dissolution of the business. If the investment of the limited partner consists of the provision of services, then the limited status is negated and the partner has the full liability of the general partner. This situation may arise when an architect enters into a partnership with a developer, or an industrial designer becomes associated with a manufacturer and contributes services in return for a share of the project.

## 4.5 CORPORATION

Unlike the partnership and the sole proprietorship, the corporation is an artificial legal entity created by the state. That is, the corporation is a legal “person.” The rights of the owners of the corporation are established by state statute, the articles of incorporation, and the wording of share certificates, and other agreements established between the corporation and the stockholders. The corporate form of organization is separate and distinct from its owners (the stockholders) and may conduct business on its own behalf, own property, enter into contracts, be liable for debts, undertake and participate in legal actions as plaintiff or defendant, etc. The corporate form of organization is used by most medium- and large-sized business and is increasingly popular for small businesses, including design practices.

Unlike the partnership or sole proprietorship, the corporation facilitates centralized management since a board of directors is established automatically for the purposes of control of the firm and the board formally appoints managers to run the firm’s operations. Interests in the firm are transferred freely by the sale of shares. It should be noted that restrictions on the transfer of shares can be established in the corporate charter; for example, in closely held corporations, shares are not traded to the general public nor provided to employees. Thus, the corporation has perpetual duration until it is terminated by the shareholders, by bankruptcy, by specific limitations in the corporate charter (or Articles of Incorporation), or by the court if the board of directors are deadlocked. The addition or loss of owners does not terminate the organization and generally does not affect the firm’s operations.

The primary advantage of the corporation is the limitation placed on individual shareholders for the liabilities of the corporation. The owners are liable only the extent of the funds that they already have invested in the corporation either through the purchase of shares or by the retention of corporate profits. The limited liability protection of the corporation (or the corporate “veil”) can be pierced in certain situations and the assets of individual stockholders sought in order to satisfy corporate obligations. For example, an exception exists when the officer-stockholders are guilty of fraudulent activities, such as when a third party/creditor is involved in business dealings with what appears to be a solvent corporation but which is, in fact, only a shell with no assets or equity capital. If the court determines that an unfair and undesirable result would occur by interposing the corporation between its owners and the injured party (where the injury is physical or occurs because the injured party reasonably would not be expected to examine the creditworthiness of the corporation or because the corporation is held as an individually or family- owned enterprise), then the corporate veil will be pierced. To avoid this potential problem, the corporation must be financed adequately, organized and operated on a businesslike basis, and its activities must be legitimate. Particular care also must be used when one corporation owns all or most of the shares of another corporation (the subsidiary) and that corporation is financed insufficiently with regard to its obligations.

Another advantage of the corporation is the ability to obtain capital by issuing liabilities such as long-term debt (as bonds or loans) or increasing equity by selling stock (common or preferred), or retaining profits from the business. The corporation also provides for a potential separation between the owners and the managers of the firm. This allows concentrated (and centralized) management and widespread ownership and gives rise to a similar problem that was discussed for the partnership. That is, the separation between ownership and management requires that owners must use resources to monitor the performance and activities of the managers to ensure that they function in the best interests of the owners and at maximum levels. This is referred to as an agency cost and involves costs of monitoring and enforcing performance. Alternatively, incentives (at additional cost) must be provided to ensure that managers are motivated to the same extent as owners.

The interface between the owners and the managers is provided by the board of directors. A board of directors is established in the articles of incorporation and the corporate bylaws when authority for decision making is delegated by the shareholders to their elected representatives. The influence of the board of directors varies; while they are always responsible for major long-term policies, they also may become involved in the day-to-day operation of the business. The level of responsibility is important because the board of directors has a fiduciary duty to the shareholders and must act in their best interests. They can be held responsible for corporate decisions and must be particularly cautious with regard to using information that is not publicly available for economic “gain” (insider trading). Perhaps the single most important decision of the board of directors is to select the officers of the corporation: president, vice president, secre-

tary, and treasurer. Much of the responsibility for the operation of the business will be delegated to these individuals, and it is essential that they be capable of performing at the maximum level. Many corporate takeovers and business failures have been the result of inept management at the top level and its failure to maximize the value of the company.

Another responsibility of the board of directors is to determine the disposition of profits of the corporation. The articles of incorporation and agreements with the firm's creditors may place constraints on profit distribution, and the board of directors is liable for unlawful dividend payments. Profits after corporate taxes may be reinvested in the firm or distributed to the owners as dividends in proportion to the number of shares held at a specified date. The payment of dividends appears to have a significant influence on the market value of a publicly traded firm, probably because the dividend conveys to the marketplace information about the performance of the firm. Most publicly funded firms follow a conservative dividend policy in which dividend payments are very stable and are increased only if the firm is certain that the higher level can be maintained in the future. In some situations the firm may issue additional shares in the company to its owners (as a stock dividend or a stock split). Unless the amount of the dividend (per share) is maintained, this is a "zero" transaction and the price of the company's stock will adjust downward automatically. Alternatively, a firm may repurchase its own shares, increasing the value of shares that are outstanding.

Dividend policy is important because the dividends of a company are taxed twice: once at the corporate tax rate as profits of the company, and again at the marginal income tax rates of the individual shareholders. Stock dividends (and splits) and increases in value resulting from stock repurchases or retention of profits for investment are not taxed to the individual until the shares are sold. At that time they are taxed at the capital gains tax rate of the shareholder (if the sale occurs after one year). Losses of the corporation are not distributed to the shareholders as losses for income tax purposes but are impounded in the share price and are realized as a capital loss if the shares are held for more than one year (and then sold).

## **4.6 THE PROFESSIONAL CORPORATION**

The registration laws in many states preclude the use of the corporation for the practice of architecture but it generally is applicable for most other design professionals that do not need to be formally registered in the state. Liability for professional services is a risk that cannot be reduced by the corporate form of organization. However, most states have allowed the practice of architecture in professional corporations, with advantages of both limited business liability and some preferential tax law provisions although still subject to corporate tax requirements. For example, the IRS allows certain fringe benefits such as pension plans that are paid to corporation employees to be deductible as legitimate business expenses for corporate tax purposes. The corporation also can be used to provide for the retirement of employees with a stock option plan. Employees can be given shares in the company during their tenure with the firm, and then those shares can be retired over time by repurchasing by the company.

The corporation form of organization generally tends to be beneficial when the firm's owners are in very high tax brackets, when there is the potential for business liability, when the firm is employee owned (so that the increased benefits of the pension plan outweigh the corporate tax cost, or when the firm is fairly small and wishes to retain as much income as possible for financing future growth. Since the 1986 Tax Reform Act, the economic incentives to form a corporation have been reduced considerably, and the advice of an accountant or lawyer who specializes in taxes and/or corporations should be obtained prior to selecting the form of organization.

## **4.7 SUBCHAPTER S CORPORATION**

This is a hybrid form of organization that combines the advantages of partnership, such as taxation (that is, double taxation is avoided), and the corporation, including the corporate "veil" for liability protection and unlimited life, etc. This type of corporation is established under Subchapter S of the Internal Revenue Code.

## **4.8 NON-PROFIT CORPORATION**

The non-profit corporation is very similar to the for-profit corporation, with the exception that no profits can be distributed to its shareholders. This type of organization is used by institutions such as hospitals and charities where tax-deductible gifts or donations are an important source of income. Some design professionals do practice in non-profit corporations, but they are not exempt from professional liability. The shareholders of the non-profit corporation are exempt from business liability for the debts incurred by the company. These firms also are exempt from taxation because they have no profit. However, it should be noted that this preferential tax status may be lost under circumstances, for example if the corporation engages in some profit making or political activities

## **4.9 JOINT VENTURE**

Joint ventures occur when two or more separate organizations combine or associate together. It is a contractual relationship that is established for either a specific undertaking, such as a building project, or for a definite period of time. As with most contractual relationships, the joint venture can involve an oral or written contract or even can be implied by the actions of the parties. If the rights and obligations of the parties are not specified, then, in the event of a dispute, it is likely that the conditions of a partnership (as expressed in the UPA) will be substituted. That is, the joint venture will be seen as having many of the attributes of a partnership for that one undertaking. For example, this means that the actions of one of the joint venture parties can bind the other(s), assuming that the third party is unaware of the condition.

There are several reasons to form a joint venture. These are:

- a. Shared resources (both personnel and other assets);
- b. Combined expertise and knowledge (for example, an architect with an engineer);
- c. Greater amounts of capital or capital-raising ability.

There are two types of joint venture: one, the fully integrated, self-supporting joint venture where the separate organizations create a new (and separate) organization which operates independently and with its own employees; and two, the non-integrated joint venture which allows the employees to remain in their respective organizations. Compensation may be calculated by splitting net profits according to an agreed-upon formula or by a compensation split which divides the compensation at the outset, and each firm subtracts its own costs to determine its profit. Efficient firms are not penalized, and monitoring costs are reduced with this technique.

A joint venture may be used by a smaller firm to obtain a large project or to obtain specialized skills that it does not have. In this situation, a memorandum of understanding is prepared between the two firms prior to the project being obtained. This memorandum may form the basis of the joint venture agreement if the project is obtained. In other situations (becoming increasingly common in the practice of architecture), a “design” firm, often located in another city, may join with a local firm that has the regional knowledge and resources to undertake the documentation and construction administration phases of a project.

## **4.10 ASSOCIATIONS**

There are several different ways for individuals to band together for a common purpose. Some of these have already been discussed, but another important category is the association. These can be unincorporated, such as a church or a social club; a professional association, such as the American Institute of Architects; or even a “loose” association, such as several design professionals sharing office space and assisting each other on projects when necessary. This latter arrangement can cause problems when the actions of the associated parties imply a partnership to others or when one of the associates fails to perform adequately. In the first instance, the association will be treated as if it were a partnership, giving rise to legal problems addressed in contractual and tort law and referred to in Chapter 5. In the second case, problems might arise if one associate performs inadequately for a client of the other. In this situation, both can be sued by the dissatisfied client.

## **4.11 SUMMARY**

Managing a sole proprietorship can be very stressful as the sole proprietor is responsible for all of the decisions of the firm. This form tends to be very entrepreneurial in nature, and the firm often operates with very few management systems and controls. Individual owners tend to believe that they are the only people in the firm who are capable of running the firm, are reluctant to delegate responsibility to their employees and, as a result, the sole proprietorship requires high energy levels and a great deal of commitment on the part of the owner.

If the practice does not develop to the next stage where additional principals are added (typically reflected in either partnership or corporation), deterioration sets in and the proprietorship often fails. The decisions and actions that help the sole proprietorship evolve are those related to the delegation of responsibility and the accessibility to additional capital and other resources.

Most architectural firms operate as partnerships because the partnership form closely approximates the functional form. That is, a collection or association of individuals with specific skills and capabilities, each in charge of departments representing those skills (efficiency-based) or responsible for projects for which they personally have obtained the commissions (convenience-based). Partners of architectural firms often want to maintain active involvement in the management of the firm. With the formation of a corporation, a cultural change often occurs with the owner-principal relinquishing management control to professional managers and concentrating on his or her individual specialties. The evolution of the architectural practice will be discussed further in the following section.



## LARKIN ASSOCIATES

Philip Larkin commenced practice as an architect in southern Ohio three years after graduating from the University of Cincinnati. His early work consisted almost entirely of single-family homes and addition or renovation projects up to \$100,000. By 1983 Larkin had expanded the size of the firm from two people in 1976 (himself and a draftsman) to ten people (six architects, an interior designer, a receptionist/typist, and two assistants/ draftsmen). During this period, the work of the firm also had undergone substantial change. Although they still received commissions for single-family residences, the projects were increasing in scale and complexity. Larkin had obtained major commissions from developers for the design of residential communities and small shopping centers during 1980-83, and the firm had begun to work closely with landscape architects and urban designers.

Generally, Larkin was displeased with the services of these consulting firms as they were not as committed to the practice of good design as was his firm. Further, he often thought that the fees charged by these consultants were extremely high and believed that his own profit margin was reduced as a result. Most of the contracts that he undertook with developers were on a fixed-fee basis, the fee being negotiated by himself and the developer. On the other hand, the landscape architects and urban design consultants were on an hourly rate. They were reluctant to specify how many hours of work would be required for a project at the outset when the budget was prepared, and it often appeared that they had no real incentive to perform efficiently. Perhaps the most depressing issue was that the hourly rate for these other professionals considerably exceeded his own rate as the principal of Larkin Associates even though their relative skills and design abilities were so much less effective than his own. Frustrated and angry, Larkin added up the most recent charges for the consultants on Wintergreen, a housing community and shopping center, to find that the total fees paid to the landscape architect and the urban designer were \$20,350 and \$16,750, respectively. It struck him as incongruous that he could employ two trained professionals in these fields for a year for less than he had paid in fees for three months of work on this project.

Larkin began to consider the possibility of adding two more people to the firm. The critical factor was whether the firm had sufficient work for them in the coming years. He reviewed the previous year's figures and the profit plan projections for 1984-86. He was confident that these projections would be realized and, probably, surpassed (by an unknown amount) so the decision to expand the range of services was made easily. Finding the space to accommodate them was less simple, and he noted that some rearranging in the loft would be necessary to fit in the extra furniture.

Over the weekend, he pondered the issues closely and decided that expanding the staff was only one element in the problem. Already with ten employees his limited time was a major source of difficulty. He was responsible for managing and marketing the firm, in addition to taking a leading role in the design of every major or significant project in the office. He considered passing some of his responsibilities to other employees. Certainly some of the architects were as capable in design as he, but design was the one facet of his daily work that he really enjoyed. The other areas of responsibility, the day-to-day management (and the marketing) of the firm, were too important to pass to inexperienced employees. Larkin observed that there were several possible solutions:

- a. Continue as a sole proprietor and utilize the services of his employees and the accountant to reduce his own workday;
- b. Take on a partner skilled in management and marketing;
- c. Employ a business manager (part-time or full-time).

One of the advantages of forming a partnership would be the opportunity to obtain additional capital from the partner. Larkin Associates had grown rapidly during the past three years and needed additional capital of \$100,000 over three years in order to finance expansion. He was reluctant to consider the alternative to forming a partnership. He previously had been approached by an engineering firm and most recently by an interior design firm. Both firms had made overtures about forming a partnership, but Larkin believed that he had worked too hard to share the rewards that were just now beginning to accrue to the firm. The formation of a partnership with another architect similarly was undesirable. Sharing responsibility for the operation of the firm would reduce his own workload, but to share directly the credit for the design projects was another matter.

Another factor of vital concern to Larkin was his increasing liability. The more employees the firm had, the more careful he had to be, checking and double-checking the working drawings prepared by the firm before affixing his seal. There were times, he mused, that his primary effort seemed to be red-lining the prints of working drawings for corrections to be made. A recent lawsuit involving a well known firm in the city had been on his mind constantly, exacerbating an already difficult situation. Work for developers was forming an increasingly large portion of the workday, and he had noticed their impatience with over-budget projects. He was being pressured constantly to design buildings of lower cost and to reduce his design time as part of the overall effort to reduce costs.

By Monday he had decided that he needed the assistance of a trained consultant, and he arranged to meet his accountant for lunch. By the end of the meeting, the issue was even less clear; the accountant had advised him to form a corporation, less for his own legal protection than to reduce his own tax liability and assist in retaining capital for investment in the firm. If he pursued the alternative of employing a manager in addition to hiring the landscape architect and the urban designer, it was apparent that the firm would need additional working capital. The accountant had counselled against borrowing additional funds to finance expansion. The firm already was highly leveraged; and although interest rates were declining, if business declined, bankruptcy would be possible.

Larkin calculated his capital needs over the next three years, assuming that his expansion plans would be accomplished.

#### ADDITIONAL CAPITAL REQUIRED

1988	\$14,000	1989	35,000	1990	50,000
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He reviewed the revised profit plans that the accountant had prepared (Appendix A) and determined his personal expenses to be:

Living expenses \$30,000 per year

Itemized deductions for \$5,000 per year tax purposes in excess of standard

Exemptions for tax \$5,000 per year purposes

Determine the course of action that Larkin should follow with regard to the legal form of the organization. Can he finance the expansion of the firm by retaining the profits from operations?

#### INCOME STATEMENT (PROJECTED)

	1988	1989	1990
Gross Income from Operations	\$381,300	\$435,700	\$485,900
Less Salaries (excluding P. Larkin)	270,000	280,000	310,000
Office Expenses (Materials, etc.)	12,000	15,000	16,500
Office Rent	20,000	25,000	28,000
Utilities	7,000	8,200	9,000
Professional Insurance	13,000	15,200	16,100
Interest	6,000	6,000	6,000
Lease Cost for Capital Items			
1. Computer	8,000(A)		
2. Automobile	2,300	2,300	2,300
3. Xerox, Printing & Typewriters, etc.	4,000	4,000	4,000
Net Income Before Taxes & Larkin's Salary	50,000	80,000	100,000

Note A. Larkin plans to acquire a computer system as part of the capital investment plan in 1985. Do not include depreciation for this case.

#### PERSONAL TAX RATES (from 1988 Tax Code)

taxable income less than \$29,750 15% \$29,751 and above 28%

where taxable income is calculated as: gross income less deduction and exemptions = TAXABLE INCOME

Taxable Income x Tax Rate (less Tax Credits) = Tax Payable

#### CORPORATE TAX RATES for 1987

taxable income \$50,000 or less 15%

\$50,001 to \$75,000 25%

\$75,001 and above 34%