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The Appropriate Business Structure: A Decision for Sport Managers

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Sport managers interested in opening up sport-related businesses such as bowling alleys, roller skating rinks, miniature golf courses, health clubs, etc. must decide on the business structure providing optimal benefits and minimal hardships. Liability, tax treatment, access to capital, managerial input and control, and ease of formation all vary among the different business structures. The type of business structure a sport business adopts greatly influences short- and long-term operations. The purpose of this paper is to examine the various business structure alternatives available to sport entrepreneurs. Although sport business entrepreneurs should consult an attorney in deciding the optimal structure, this paper summarizes key facets associated with each business structure alternative and provides the sport manager with a rudimentary understanding of related concepts.

Traditional business formations include the sole proprietorship, the general partnership, the limited partnership, the S corporation, and the C corporation. States, in an effort to attract new businesses (interstate and global) and enhance the retention rates of existing businesses, pass legislation to make business structure choices more favorable. Two recent examples of this process are the limited liability corporation (LLC) and the limited liability partnership (LLP). Part I of this paper briefly reviews advantages and disadvantages commonly associated with the: (a) sole proprietorship, (b) general partnership, (c) limited partnership, (d) s corporation, and (e) c corporation (Tables 1-5).[1] Part II elaborates on the LLC including its advantages and disadvantages (Table 6). Part III discusses the LLP as well as its advantages and disadvantages (Table 7). Part IV analyzes the criteria used to ascertain whether an entity should be taxed as a corporation or a partnership. Part V analyzes the criteria used to ascertain whether the veil of limited liability should be pierced. Part VI offers some concluding comments.

Part I(a): The Sole Proprietorship - Advantages

Artisans and entrepreneurs adopted the sole proprietorship business structure during the preindustrial era. The sole proprietorship remains a popular business structure for many sport business owners. For example, sole proprietorships accounted for 19% of all public golf courses,[2] 14% of all membership sports and recreation clubs,[3] 32% of all sporting goods and bicycle shops, and 20% of all physical fitness facilities in 1992 (Tables 8-11). Sport business proprietors own the particular business assets and assume all financial responsibilities. Adoption of the sole proprietorship business structure includes seven significant advantages.

First, a sport entrepreneur retains total control over all business issues including competitive strategy, budgeting, and marketing tactics. Lengthy consultation, persuasion, and negotiation among individual partners or a Board of Directors is eliminated. A sport business entrepreneur seeking to circumvent the need for, and time devoted to, consensus building finds the sole proprietorship very appealing.

Second, the sole proprietorship benefits from single taxation. Individual tax rates apply to generated business income. The sport business, as a separate entity, escapes payment of corporate taxes on generated income.

Third, the ease of formation appeals to individuals eager to establish a sport business in a effi-

[1] All tables are at the end of the article.

[2] The U.S. Department of Commerce defines the public golf course as a privately operated establishment primarily engaged in the operation of golf courses open to the general public on a fee basis. Municipal golf courses are not included.

[3] The U.S. Department of Commerce defines membership sports and recreation clubs as those clubs which maintain facilities for use by only their members and guests. Country clubs, golf clubs, tennis clubs, yacht clubs and swim clubs are included in this category.

cient and effective manner. Typically, minimum requirements include only a "business license obtained from the city and a tax permit obtained from the state" (Ellis and Norton, 1988, p. 42).

Fourth, the flexibility inherent in the sole proprietorship attracts potential sport business managers. It enables a sport entrepreneur to implement ideas rapidly and secure first-mover advantages. First-mover advantages are important when: (a) brand identity is important to the buyer; (b) gains via the learning curve can be realized, (c) entry barriers can be established, (d) switching costs can be secured and (e) cost advantages can be gained via first access to raw materials, distribution channels, etc. (Porter, 1980). For example, a sole proprietor in the business of manufacturing ski equipment, seeing an opportunity in ski retail, avoids the often cumbersome process of changing the articles of incorporation in order to sell skis. In comparison, a corporation must change its articles of incorporation in such instances. Consequently, a sole proprietor can implement and adjust to opportunities much more rapidly. This flexibility allows a health club, for example, owned by a sole proprietor to expand to another ideal site without having to secure partnership consensus. Further, the sole proprietorship can be easily converted to another business structure (e.g., corporation, partnership) as desired.

Fifth, a sport business operated as a sole proprietorship, partly due to the entity's smaller size, avoids numerous government and legislative restrictions imposed on other types of business formations. For example, sole proprietors typically avoid antitrust scrutiny. Antitrust laws attempt to protect the small business against the unfair trade practices and other monopolistic ploys of big business. Further, some legislation (e.g., Title VII, Family Medical Leave Act, and the ADA) qualifies the number of employees an entity must have prior to the mandate of legal compliance. A sport businesses operating as a sole proprietorship with few employees spares the expense of compliance.

A sixth attraction, total profit retention, benefits the sole proprietor as well. A sport entrepreneur, working long hours to provide the consumer with a quality, high demand product, often faces significant frustration when forced to share profits with those contributing far less in managerial expertise, time, or idea generation.

Seventh, a sole proprietor maintains confidential operations better than an owner of an alternative business structures. Consequently, the adoption of a sole proprietorship business structure provides protection against a competitor's ability to imitate or sabotage product introductions, marketing campaigns, and other competitive strategies. A sport business entrepreneur, cognizant of the substitutability of any one product, views the confidentiality feature favorably.

Part I(b): Sole Proprietorship - Disadvantages

The following section elaborates on five significant disadvantages a sport business may incur when organized as a sole proprietor. First, access to capital presents a formidable limitation. Launching a new sport business requires adequate capital to cover start-up expenses as well as to fund growth via new equipment, expanded personnel (inhouse or outsourced), geographic expansion, program expansion, or target market expansion. Unfortunately, a sport business proprietor, due to a number of factors, including limited capital, lack of experience, and/or unproven business capabilities may find borrowing unavailable and/or too expensive. Unavailable or inaccessible capital forces a sport business entrepreneur to pass opportunities and market share on to other competitors possessing greater capital resources.

Second, limited managerial expertise stagnates the profitability and viability of a sole proprietor operating a sport business. Few sole proprietors possess highly specialized knowledge in *all* of business's functional areas (e.g., management, marketing, budgeting). Even if a sport business entrepreneur possesses expertise in all functional areas, time restrictions make the optimal development of each area unlikely. The sole proprietorship business structure hinders the attainment of premier employees as well. The scarcity of promotion opportunities forces job candidates possessing functional expertise to look at larger, competing organizations better equipped to provide more autonomy, empowerment, responsibility, status (e.g., office, job title), remuneration, benefits and deferred compensation plans (e.g., stock bonus, profit sharing, 401K). This lack of managerial expertise places the sport business at a competitive disadvantage in comparison to competitors operating with other business structures.

Third, unlimited liability often constitutes the dominant disadvantage associated with the sole proprietorship business structure. The risk inherent to sport, coupled with a litigious society, magnifies concerns regarding unlimited liability. Unlimited liability provides creditors and tort claimants access to personal investments and properties (e.g., car, home) when a sport business cannot cover debt or the claims against the assets. Further, a person may work for

years to pay off incurred debts if losses do exceed personal wealth.

Fourth, the life of an individual sole proprietor defines the longevity of a particular sport business. The death or incapacity of the sport proprietor brings about the dissolution of the particular sport business. Disadvantages accrue even when the sport business is rejuvenated. For example, creditors may question the financial and managerial integrity of the new owner, customers may defect during the "reorganization" period, personnel changes may influence existing consumers to switch from one sport product provider to another, and monies and time are lost as a result of paperwork.

Part I(c): The General Partnership - Advantages

A general partnership consists of two or more persons organized to engage in a businesses (or businesses) for profit. The partners exist as co-owners "and share equally in the operation, management, and liability of the business" (Ellis and Norton, 1988, p.44). In 1992, the partnership business formation was adopted by 10% of all public golf courses, 7% of all membership sports and recreation clubs, 5% of all sporting goods and bicycle shops, and 6% of physical fitness facilities (Tables 8-11).[4] The general partnership presents sport businesses with three primary advantages unavailable to the sole proprietor.

First, a sport business formed as a general partnership provides greater access to capital resources than that available to a sport business proprietor.[5] Access to capital enables the partnership to take better advantage of opportunities and trends resulting in greater revenue generation, increased market share, and enhanced customer satisfaction. As mentioned above, capital availability provides a sport business with needed monies for new distribution outlets, geographic expansion, the additional hiring of personnel, and/or the provision of product extensions.

Second, a sport business formed as a partnership enhances the internal degree of managerial talent. "Multiple minds," or pooled intelligence, is likely to produce better sport business decisions in comparison to a single entity or a "single mind." Further, individual partners possessing distinct qualities and expertise are better able to address diverse market demands and company needs. Banks and other lenders look favorably on the pooled collateral and the pooled managerial expertise as both of these factors reduce creditor risk.

The benefits of capital access and managerial talent reflect, in part, revenues generated. As illustrated in Tables 8-11, sport businesses formed as partnerships generated more revenue per establishment than the sport businesses operating as a sole proprietor in the years 1977, 1982, 1987, and 1992 in the following industries: (a) public golf courses (Table 8), (b) membership sports and recreation clubs (Table 9), (c) sporting goods and bicycle shops (Table 10), and (d) physical fitness facilities (Table 11) (1987 and 1992 data available only) (Census of Retail and Service Industries, 1977, 1982, 1987, 1992).

Third, similar to a sport business proprietorship, yet deserving of more comment, the general partnership as an entity avoids paying corporate taxes on generated revenues. Rather, this income is "passed through" and added (profits) or subtracted (losses) from other generated income. As explained by Booth (1995, p. 550),

> The primary purpose of a tax shelter is to generate losses (at least in the early years of operation), thus generating gains — in the form of tax savings — that have little to do with the success or failure of the business.

A particular sport businesses may not worry if it produces a loss. Instead, a sport business may favor generated losses as a way to reduce tax payables. For example, if an individual's income amounted to $150,000, the accompanying tax liability would amount to $43,370.50 (single filing status, 1995 tax rate schedule). If, however, that individual had a $75,000 loss associated with Health Club ABC, the individual partner's tax liability would be reduced to $18,518. On the other hand, profits earned by the partnership increase individual tax liabilities. According to the IRS, an average of 56% of all partnerships reported a loss between 1985 and 1993 (IRS, 1987-1995).

Part I(d): The Partnership - Disadvantages

Two primary disadvantages incurred by the

[4] The census data reports partnerships at large and does not distinguish between general and limited partnerships (see Census of Retail Trade and Census of Service Industries).

[5] Although an advantage in comparison to the sole proprietorship, the capital available to the general partnership is limited in contrast to other business structure alternatives (i.e., the corporation). Similarly, the limited capital and promotion/ownership opportunities of a partnership hinders securement of the best managerial talent in comparison to the corporation.

sport business operating as a general partnership include: (a) the limited longevity of the entity itself and (b) joint and several liability. The partnership lacks continuity of life because the firm "is necessarily dissolved by withdrawal, bankruptcy, or death of a partner" (Bromberg & Ribstein, 1995, p. 196). The rational associated with dissolution of the partnership by the withdrawal of any one member is explained by McGuire (1989, p. 302-303),

> A partnership is a combination of persons, each bringing unique abilities and credit ratings to the business. Parties dealing with the firm may rely on the joint abilities and credit of the firm's members, and each partner relies on the abilities and credit of his or her partners as well. If a partner leaves the firm, that combination of abilities and credit has been changed. As a result, the creditors and remaining partners should be given the opportunity to reassess their relationships with the firm in light of the changed circumstances.

Limited longevity jeopardizes established relationships with creditors and consumers while interrupting the general cash flow of the sport business.

Second, similar to the sole proprietorship, the individual partners in a sport business partnership possess unlimited liability and consequently endanger personal assets. Further, the general liability of a general partner includes liability for individual errors and omissions, in addition to joint and several liability for the acts of other individual partners. Partners are individually liable for the acts of another partner regardless of consent, actual, or constructive notice. Individuals within a partnership attempt to prevent errors and omissions by "monitoring" or looking into each other's activities. However, the act of monitoring presents a limitation as it restricts the size, and resultant economies of scale, of any one partnership. Further, resources (both time and money) spent in monitoring each other's activities detract from productivity and efficiency. The unlimited liability of individual partners discourages passive investors and thwarts opportunities dependent upon access to additional capital. The era of litigation and the risk-prone nature of sport magnify this limitation. However, legislation in the 1980s curbed many problems associated with the joint and liability of general partners. As reported by the American Tort Reform Association (Middleton, 1995), forty one states modified or abolished joint and several liability since 1986.

Part I(e): The Limited Partnership - Advantages

A limited partnership consists of one or more general partners who retain full liability for the business and "limited" or "special" partners who invest monies and, in turn, receive a proceed of generated income proportionate to one's investment. Sport business managers typically manage the operation (e.g., serve as the general partners) while individuals often unfamiliar with the sport product itself serve as removed investors (i.e., limited partners). A sport business operating as a limited partnership realizes four primary advantages.

First, a limited partner retains no liability for the claims against the organization's assets. Rather, a limited partner's loss mirrors the amount invested.

Second, the limited partnership provides attractive investment opportunities for individual investors. Investors, realizing the liability risks encountered with sport and fearful of the joint and several liability associated with the general partnership, find the limited partnership a viable investment. The sport business, on the other hand, benefits from the capital infusion.

Third, a limited partnership provides the investor with an opportunity to strengthen individual earnings while simultaneously obtaining a diversified portfolio. Investors often find sport businesses attractive investments as demand for sport-related products continues to increase. Serving as a limited partner allows individuals to spread wealth without inordinately expanding liability risks.

Fourth, the limited partnership provides individuals with a tax shelter as limited partners retain pass-through tax benefits associated with the general partnership. The ability to deduct generated passive losses (those losses incurred from businesses in which the individual does not materially participate) from passive income (e.g., dividends, interest, annuities, and gains from the sale or exchange of stock and securities) lowers tax liabilities.

Part I(f): Limited Partnership - Disadvantage

The inability of a limited partner to provide input regarding management-related issues constitutes a primary disadvantage of a sport business considering the limited partnership business structure alternative. Limited partnerships jeopardize classification by the IRS and the courts when limited partners participate in the management of the sport business itself. Unfortunately, individuals investing large sums of money may prefer to have input when strategic decisions directly influence the profitability of their investment. Consequently, potential investors wanting to exercise some control over business op-

erations often choose to invest in sport businesses with alternate business structures.

Part I(g): The S Corporation - Advantages

Congress created the S corporation in 1958 as a vehicle to foster small business success by recognizing a business structure which combined the best of the partnership and the corporation into one entity. S corporations grew in number after President Reagan's Tax Reform Act (TRA) of 1986. As stated by IRS, S corporation filings increased an average 14.1% per year between 1986 to 1992 (1995). The TRA lowered both corporate and individual tax rates. But more importantly, the corporate tax rate now exceeded individual tax rates (34% versus 28%). A sport business formed as a S corporation avoids paying the higher corporate tax rate. Individuals pay lower taxes on pass through income versus paying both the higher corporate tax rate plus taxes on distributed income. The S corporation contains six primary advantages.

First, a sport business formed as a S corporation eliminates the joint and several liability of the general partner. All S corporation member-shareholders, similar to the traditional corporate entity, bear limited liability and personal assets cannot be accessed to pay claims against the entity itself. Similar to the corporation and the limited partner, an individual shareholder can lose only the amount invested.

Second, similar to the partnership, the S corporation eliminates the financial hardship associated with double taxation. The generated income passes through to individual shareholders. A sport businesses formed as a S corporation pays no federal corporate income tax.

Third, a sport business formed as a S corporation increases access to capital via stock distribution opportunities. Sole proprietors and partnerships recognizing this advantage, often change to a S corporation as a sport business grows and needs capital.

Fourth, a sport business formed as a S corporation secures managerial talent better than either the sole proprietorship or the partnership. The wisdom of prudent employees enhances the competitive strength and positioning strategies of any sport business.

Fifth, the S corporation avoids the alternative minimum tax (AMT). The AMT taxes items such as tax-exempt interest, passive losses, and deductions claimed for charitable contributions in an effort to ensure that wealthy individuals and corporations pay income tax (IRS, 1995). In comparison to the C corporation, AMT tax avoidance lowers a sport business's cost structure and enhances competitive positioning.

Sixth, sport medicine personnel find the S corporation attractive for another reason. Personal service corporations (PSC) can form a S corporation and escape the flat tax rate while retaining limited liability. As a C corporation, personal service organizations incur a flat tax of 34%. In other words, a PSC generating $60,000 would be taxed at 34%. In comparison, an S corporation would be taxed at lower individual rates. To quantify, lets assume a PSC generates $50,000 of net income. A single individual, assuming no other income, would incur a tax liability of $10,964.50 (1995 tax filing schedules). As a C corporation, the tax liability amounts to $17,000.

Part I(h): The S corporation - Disadvantages

Three restrictions associated with the S corporation can yield significant disadvantages. First, the following four qualifying restrictions limit the ability of the sport business formed as a S corporation to expand and acquire needed capital.

1. The S corporation is limited to 35 shareholders.
2. The S corporation can issue only one class of stock.
3. The S corporation may not own 80% or more of the stock of another corporation.
4. Shareholders of a S corporation can only be U.S. citizens or resident aliens. (There can be no corporate or partnership shareholders.)

However, the S corporation serves as an ideal business structure for small or new sport businesses which can later change to less restrictive alternatives when needs for new capital appear.

Second, the S corporation prohibits employee-shareholders from borrowing money from pension plans (allowed in C corporations). Consequently, the S corporation alternative can hinder access to needed or valued employees desiring this benefit.

Third, an employees' benefits can be deducted as a business expense only when the employee-shareholder owns less than 2% of the corporate stock. An employee owning in excess of 2% of the stock "must declare 75% of those premiums as income and pay income, Social Security, and Medicare payroll taxes on the amount" (McQuown, 1992, p. 124). Consequently, a sport business formed as a S corporation may lose tax-favored fringe benefits including medical and insurance plan writeoffs.

Part I(i): The Corporation - Advantages

Chief Justice Marshall defined the corporation in 1819 (Dartmouth College v. Woodard) as follows: "A corporation is an artificial being, invisible,

intangible and existing only in the contemplation of the law." The evolution of the corporation is a direct result of business growth. Demands for capital, liability protection for owners, order and accountability prompted the recognition and growth of corporate formations. In 1992 corporations accounted for 70% of all public golf courses, 78% of membership sports and recreation clubs, 64% of sporting goods and bicycle shops, and 73% of physical fitness facilities.[6] A corporation offers a sport business six primary advantages.

First, due to the corporation's ability to issue shares in accordance with its articles of incorporation, a sport business can access needed capital. This access to capital places the sport business formed as a corporation at a strategic advantage in comparison to other business formation alternatives as capital availability provides for market or product expansion.

Second, the liability of each shareholder/owner reflects only that amount invested by the individual shareholder. Recognized by the IRS and the courts as an individual, the corporate sport business maintains liability for its own debts while the personal wealth of the shareholder remains protected.[7]

Third, available and/or accessible resources enable the corporation to secure the best sport management personnel. A sport business formed as a corporation can attract premium employees via stock ownership, promotional opportunities, large salaries, and deferred compensation plans.

Fourth, the corporation can decrease tax liabilities for small or one-person entities. For example, assume a sport business generated net income of $75,000. As an individual sport business proprietor, this $75,000 would incur a tax of $18,518 (individual filing, 1995 tax schedule). However, if the individual splits net income 1:2 ($25,000 salary and $50,000 retained corporate earnings) the total tax liability amounts to $12,652 ($7,500 corporate tax + $5,152 individual income tax) or a savings of almost $6,000.

Fifth, dividends received from corporate investments remain 70% tax-free (i.e, corporate income tax is not paid on these revenues). This constitutes a significant tax advantage for a large sport business with prudent investment strategies. A sport business can use the tax savings to produce a better, more diversified product line or otherwise improve competitive advantage.

Sixth, as a corporation, individual executives often find greater ease in doing business (McQuown, 1992). A sport business formed as a corporation often experiences less resistance and scrutiny in accessing credit, ordering inventory, etc. due to established corporate accounts.

Part I(j): The Corporation - Disadvantages

Four primary disadvantages a sport business encounters when formed as a corporation include: (a) double taxation, (b) the separation of management and ownership, (c) the extensive corporate formalities requirement, and (d) government scrutiny. First, the corporation, as an entity separate from its managers and owners, pays corporate income taxes. Viewed as an individual person, the sport business formed as a corporation must pay taxes as do individual tax payers. In addition to the corporate tax, individual shareholders pay taxes on distributed dividends at their respective tax rates. As a result of this double taxation, shareholders receive only a diluted portion of original earnings. The accumulated earnings tax, a tax on retained earnings above a specified amount, discourages companies from retaining monies to avoid the double taxation. The accumulated earnings tax enables the IRS to tax the retained earnings by as much as 75% (McQuown, 1992). Consequently, a sport business may find it most economically advantageous to pay dividends regardless of the double taxation.

Second, owners (i.e., shareholders) typically play an inactive role in the management of a larger sport business formed as a corporation. Management scholars have criticized this separation of ownership and management (Drucker, 1992). Critics argue that the separation of management and ownership results in goal conflict as managers of a sport business focus on short-term results at the expense of long-term objectives. For example, sport managers may emphasize those activities which enable them to meet quarterly financial quotas (selling a certain volume of product regardless quality or defect rates). From the perspective of the sport managers, acquisition of short-term goals provide job security while enhancing bonus or merit opportunities. On the other hand, maintaining company image or product

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[6] The census data does not demarcate between S corporations and C corporations. However, the inclusion of S corporations with C corporations explains why revenue per establishment is often below that of the partnership as the majority (83%) of S corporations have 1-2 members (see the Statistics of Income Bulletin published by the IRS, 1992).

[7] Although a rarity, the courts have recognized situations which dictate the piercing of the "corporate veil" and liability is transferred to the shareholders (see Part V below).

quality becomes secondary. Corporate downsizing further reinforces the need for sport managers to meet or exceed short-term objectives.

Third, in comparison to other business structures, the sport business operating as a corporation subjects itself to more intricacies regarding corporate organization, structure, voting, and other shareholder rights. The required formalities increase expenses and delay the implementation of competitive strategies while jeopardizing strategic opportunities.

Fourth, a large sport business formed as a s corporation undergoes more extensive government scrutiny than does a sport business adopting an alternative business structure. Government, in an attempt to protect innocent consumers against the power of corporate monopolies and oligopolies, enacts laws restraining operations. For example, the Sherman Act, the Clayton Act, the Hart-Scott-Rodino Antitrust Improvement Act, and the Federal Trade Commission all attempt to regulate business in the best interests of free trade and the consumer. Compliance with the various laws can be an onerous, expensive task for a sport business formed as a corporation.

Part II: The Limited Liability Company

The LLC, although an entity long recognized and popular in foreign countries (principally Central and South America), did not reach America until introduced by Wyoming in 1977 (Goforth, 1995; Horwood and Hechtman, 1994). Regardless of the other long-standing business structures mentioned above, both legal commentators and IRS officials view the LLC as the business structure of the future (Fox, 1994). Some commentators go so far to argue that the LLC may eventually bring about the demise of the partnership (Johnson, 1983). As explained by Macey (1995, p. 437),

> If this prediction proves correct, a business environment may emerge in which all firms except sole proprietorships would enjoy the benefits of limited liability, and all firms except publicly traded corporations could enjoy the benefits of pass-through tax treatment.

The real revolution in LLC business formation emerged in 1988 when the IRS formally recognized the LLC as a partnership for federal income tax purposes (Rev. Rul. 88-76). By January 1, 1995, every state had LLC statutes except Hawaii, Massachusetts, and Vermont (Bamberger and Jacobson, 1995). The rapid adoption of the LLC is attributed to state legislatures' interest in attracting business (both domestic and foreign) and related revenues (Goforth, 1995; Johnson, 1983). States, although forfeiting franchise taxes from entities formed as C corporations, recognize that the increased economic vitality produced by the LLC alternative outweighs the loss in tax dollars.[8] Booth (1995) expects every state to recognize the LLC by late 1995 or 1996.

Part II(a): The LLC - Advantages

The LLC presents three primary advantages. The paper previously addressed two advantages common to other business structures, limited liability and partnership tax status. A third benefit focuses on the flexibility allowed within the LLC, especially when compared to the S corporation. Unlike the S corporation which prohibits other corporations or partnerships from becoming shareholders, the LLC extends membership opportunities to these entities. In addition, the LLC permits an unlimited number of members so long as there are at least two members (with the exception of NY which recognizes 1 member LLCs). Further, the LLC business structure encourages parent-subsidiary structures. In comparison to the S corporation, there are no qualifications limiting the percentage of stock a LLC can hold in another corporation. The establishment of parent-subsidiary relationships serves as a competitive advantage due to common linkages and shared functions (e.g., marketing, distributions). Some states permit the perpetual existence of a LLC, a benefit not available to the partnership or sole proprietorship.

Part II(b): LLC Disadvantages

The time and expense required to convert from a partnership to a LLC constitutes a disadvantage of the LLC. As explained by Hester (1994, p. LLP-7),

> Difficulties relating to negotiating and drafting the agreements and documents required to convert an existing partnership to a LLC or other form of entity are often cited as major obstacles to such a conversion.

The newness of the LLC business formation and its lack of established precedent constitutes a sec-

[8] Although, as explained by Macey (1995), some states and local ordinances require LLCs to pay business taxes. For example, New York City requires that LLCs pay a 4% partnership tax (similar to the required tax payment for partnerships).

ond disadvantage associated with this business structure alternative.

Part III: The Limited Liability Partnership

The limited liability partnership (LLP) represents the newest type of business structure alternative. Texas introduced the first LLP in 1991.[9] The primary intent of the LLP was to provide professional service partnerships (e.g., accounting, medical and legal practices) the opportunity to retain the traditional partnership structure while eliminating risk due to joint and several liability.[10] Only NY currently restricts the LLP to professional service organizations. As explained by Hester (1994, p. LLP-4),

> A common approach is to shield a partner from partnership debts, liabilities or obligations incurred while the partnership is an LLP and arising from the negligence, malpractice, wrongful act or misconduct committed by another partner, employee or agent of the partnership, unless the negligence, malpractice, wrongful act or misconduct was committed by someone under his direct supervision and control.

By 1994 18 states had adopted LLP legislation while three other states had legislation pending. By 1995, 34 states had adopted LLP legislation.

Part III(a): The Limited Liability Partnership - Advantages

The LLP provides three significant advantages, all of which have been discussed above. First, a LLP retains the pass-through tax benefits associated with the traditional partnership. Second, a LLP can be easily formed in comparison, for example, to the complexities associated with a corporation. Third, a LLP provides limited liability. The first two elements should be familiar to the reader. The limited liability associated with the LLP, however, has its own interesting evolution. The earliest LLP statutes protected partners from acts of negligence only. Individual LLP members retained liability for contractual wrongs. Other statutes provided immunity for tort claims with the exception that individual partners would be liable for the acts of those they supervised. As revealed by Hester (1994), 14 of the existing 18 LLP statutes in 1994 contained partner liability for those supervised and/or when a partner had actual knowledge of another's errors and omissions. Later statutory amendments and newly enacted LLP statutes more closely resemble corporations or LLCs which offered protection from virtually all partnership obligations including both tort and contract. Further, statutory language may provide partners with both contribution and indemnification rights.

Part III(b): The Limited Liability Partnership - Disadvantages

Similar to the LLP, the conversion expense and the lack of established precedent constitute the primary disadvantages associated with this type of business structure.

Part IV: Partnership v. Corporate Status — A "Taxing" Issue

As noted throughout the above analysis, pass through tax benefits can decrease tax liabilities. An understanding of the analysis used by the IRS and the courts in distinguishing whether a particular entity qualifies as a partnership or corporation for taxation purposes protects a sport business from erroneously acting in ways that jeopardize or eliminate this benefit. The Supreme Court defined a corporation by the following six attributes in Morrissey v. Commissioner (1935):

1. Associates;
2. An objective to carry on a business and divide the gains therefrom;
3. Continuity of life;
4. Centralization of management;
5. Liability for corporate debts limited to corporate property; and
6. Free transferability of interests. (Booth, 1995, p. 546)

The Supreme Court, the IRS, and subsequent legal literature agree that the first two attributes, having associates and an objective to carry on a business and generate revenues, characterize most all businesses. For example, associates (e.g., individuals) collectively represent both a partnership and a corporation. Further, the objective to generate profits and divide according to predetermined agreements also characterizes both the partnership and corporation. Supreme Court analyses focus on whether a particular entity possesses one or more of the remaining four characteristics (numbers 3-6 above). The IRS views businesses possessing three or more of the four characteristics as a corporation. The IRS treats businesses with only one or two of the four characteristics as a partnership. Again, a familiarity with the analysis benefits a sport manager wanting to retain the pass-through taxation benefits associated with the traditional partnership. The fol-

[9] Texas adopted the statute primarily as a means of protection for law and accounting firms who were being sued by the numerous savings and loan and thrift associations that failed in the 1980s (Bromberg and Ribstein, 1995).

[10] Most service organizations preferred the partnership structure as the personal holding corporation do not have the same tax benefits as general business and professional corporations.

lowing paragraph briefly elaborates on the meaning associated with items 3-6 listed above.

The third element, continuity of life, refers to the perpetual existence of the corporate entity regardless of the "death, retirement, resignation, incapacity, bankruptcy or insolvency of one or more of its members" (Goforth, 1995, p. 1211). The fourth element, centralization of management, refers to the vested authority of the Board of Directors to set corporate policy and appoint management responsible for the daily operations. The fifth element, limited liability, refers to the shareholders immunity for claims against the corporation. The sixth element, free transferability of interests, refers to the ability of all owners to transfer ownership interests, both managerial and financial, without the consent of any other owner.

To summarize, LLCs and LLPs must lack any two of the following: (a) continuity of life, (b) centralized management, (c) limited liability, and (d) free transferability of interests. The subsequent paragraphs analyze each of the four characteristics in more detail as they pertain to the LLC and LLP.

a. Free transferability of interests

Both LLCs and LLPs tend to lack free transferability of interests. Free transferability of interests exists when members can transfer both financial and management or governing rights to another nonmember without the consent of the other LLC or LLP members. As explained by Booth (1995, p. 597),

> Typically, with minor and unimportant variations, the statutes forbid the LLC members from transferring an interest in both the economic and the governance rights to a nonmember unless either all or a majority of the non transferring members consent to the transfer.

Although some statutes allow the LLC members to transfer economic rights, very few allow the transfer of both economic and governing rights. LLPs tend to lack free transferability of interests as well. LLCs and LLPs prefer to limit the transferability of individual interests for three reasons. One, partners, due to joint and several liability, remain very selective regarding partnership admissions. Although most LLPs limit tort liability, some statutes retain liability for contractual claims. Consequently, partners or entity members want input regarding the transfer of memberships due to possible contractual liability as a result of another's actions. Two, continuing the tradition of non-transferable partnership rights clarifies to interested parties (e.g., the IRS and the Supreme Court) that the entity operates as a partnership. Third, although a rarity, the "corporate veil" of an entity may be pierced in certain circumstances (see Part V) as a result of individual member activities (e.g., fraudulent behavior). Member scrutiny via limited transferability of rights helps protect individuals against the unforeseeable acts of partners.

b. Continuity of life.

Similar to the lack of free transferability of rights, LLCs and LLPs both tend to lack continuity of life as well. As defined by Wirtz and Harris (1995, p. 55), an organization lacks continuity of life when the "death, insanity, bankruptcy, retirement, resignation, or expulsion of *any* member will cause a dissolution of the organization." However, the IRS allows continued existence if either "all or a majority of the members agree to continue the business" (Booth, 1995, p. 592). Since the continuation of the business requires member approval, and thus not assured, the IRS rationalizes that an entity lacks continuity of life.

LLPs tend to adopt the Uniform Partnership Act, Section 29, characteristic of dissolution upon the disassociation of any one partner. As mentioned above, retention of traditional partnership characteristics ease classification efforts by the IRS and the courts.

c. Centralized management

Centralized management exists when a particular individual or group of individuals have total authority to manage and direct entity operations. Evidence that managers resemble corporate board members tends to characterize the entity as an association subject to corporate taxation. Wirtz and Harris (1992, p. 383) state,

> An organization has centralized management if any person (or any group of persons not including all of the members) has continuing, exclusive authority to make the management decisions necessary to the conduct of the organization's business and such authority does not require ratification by members of the organization.

LLCs can engage in either management by its members (i.e., non centralized management) or management by members or non-members elected or selected by some designated process (i.e., centralized management). Most LLC members prefer the member-management option (Fox, 1994). LLC members prefer direct involvement in the LLC affairs as a means of protecting their investment (Fox, 1994). As explained by Fox (1994, p. 1152), "participation in management is the rule rather than the exception." However, some LLCs engage in centralized management to attract passive investors seeking a steady return on investment while retaining limited

liability.

Similar to the LLCs, most all LLPs are directly managed by members in the partnership. As summarized by Bromberg and Ribstein (1995, p. 121),

> Management decisions have important consequences for partners who have invested their human capital even if they are not personally liable for the firm's debts.

The LLP statutes providing liability for supervisory activities creates an additional concern regarding participatory management. Again, the potential for injury in the realm of sport magnifies the need of a sport business manager to closely scrutinize subordinate activities.

d. Limited liability

Limited liability indicates that sport business individuals remain free from liability for the debts and obligations of the LLC. The limited liability provision contains one of the most attractive characteristics to sport businesses operating as either a LLC or a LLP as the amount of personal loss reflects only the amount of individual investment. As stated by Macey (1995, p. 447),

> LLCs are not liable, directly or indirectly (or by way of indemnification, contribution, or otherwise), for the debts, obligations or liabilities of the firm. Similarly, unlike in the partnership context, members are not liable for the tort or contractual obligations of other members of the firm, even when those obligations have been incurred in the conduct of the firm's business.

A sport business entrepreneur often views limited liability as a prerequisite to engaging in business due to liability concerns.

Part V: Piercing the Corporate Veil - Protection for the LLC and LLP

As explained above, LLCs and LLPs provide significant advantages for sport business shareholders by curbing the extent of taxation and limiting personal liability. However, the veil of limited liability, although a fundamental tenant of corporate law, faces continued challenge in the courts because of perceived social injustice. As explained by Black (1990, p. 1148), piercing the corporate veil is,

> The doctrine which holds that the corporate structure with its attendant limited liability of stockholders may be disregarded and personal liability imposed on stockholders, officers, and directors in the case of fraud or other wrongful acts done in name of corporation.

A sport business manager can protect individual shareholder wealth by understanding the analysis undertaken by the courts when ascertaining if a business's actions necessitate the imposition of individual liability. Case law precedent establishes the analyses used by the courts when considering corporate veil piercing.[11]

The newness of the LLC and LLP and the resultant lack of precedent provides nominal situations in which the piercing of the corporate veil doctrine has been applied to these new business formations. However, legal experts predict that the same analysis applied to a corporation will also be used to ascertain when, and if, the veil of a LLC's or LLP's limited liability protection should be discarded (Fox, 1994; Thompson, 1991). LLP statutes, for example, in Colorado, Minnesota, and North Dakota specifically make provisions within their state statute's that apply corporate law standards to veil piercing.

The four commonly cited reasons justifying judiciary intervention into the otherwise sanctity of limited liability include: (a) fraud, (b) improper adherence to corporate formalities, (c) the issue of separateness, and (d) inadequate capitalization. The following paragraphs elaborate on each of these four reasons.

a. Fraud

As explained by Easterbrook and Fischel (1985, p. 112), fraud may occur,

> When a corporation misrepresents the nature of its activities, its ability to perform, or its financial condition. Less obvious situations crop up when a firm misleads a creditor into believing that it would have recourse to the assets of other corporations in the event of nonperformance.

The commission of fraud and the resultant liability incurred by corporate shareholders appears harsh. Shareholders, not involved in the management of the business itself, lack knowledge about (or involvement in) the fraudulent behavior itself. The social justice of imposing liability on non-involved shareholders remains questionable. However, the imposition of liability on individual LLC and LLP members appears more plausible due to the individual's direct involvement in the management of the busi-

[11] Piercing the corporate veil appears to be of little threat to LLP partners, LLC members, and corporate shareholders. As revealed by Thompson's research (1991), only 14% of all cases challenging an entity's limited liability were tort-related. A total of 1,572 veil piercing cases were analyzed. Of the 226 tort-related cases analyzed, only 31% were actually successful in piercing the corporate veil.

ness. One can deduce that LLCs and LLPs involved in fraudulent acts will not be able to hide behind the veil of limited liability.

b. Adherence to corporate formalities

Corporate formalities refer to items such as the election of directors or officers, issuance of stock certificates, maintaining corporate records, and holding meetings (Fox, 1994). For example, a typical formality for the majority of LLCs includes filing of articles of organization. Articles of organization typically contain the entity's name, purpose, and address. The filing notifies creditors of the shareholder's limited liability. Creditors then enter into contractual agreements with knowledge regarding recourse possibilities. However, state statutes minimally define required LLC and LLP formalities. For example, as of 1995, LLP statutes include at minimum a filing requirement and application identifying factors such as the name, number of partners, and a brief business statement (Hester, 1994). Adherence to such corporate formalities can be accomplished with little effort and expense. There is little to suggest that LLCs and LLPs jeopardize limited liability protection by failing to follow such innocuous requirements.

c. Inadequate capitalization

Veil piercing due to inadequate capitalization poses the biggest threat to LLCs and LLPs as it has drawn the most scrutiny by the courts (Fox, 1994). Consumer advocates view access to capital (either the firm's or an individual's personal assets) as critical to satisfy a plaintiff-claimant wrongly injured by an entity. LLC and LLP statutes try to pacify such societal concerns by either imposing capital requirements or mandatory insurance. For example, a number of statutes prohibit distributions to LLC members unless LLC assets exceed debt (e.g., Arizona, Iowa, KS, La, Md, Minn, Nev., OK, Tx, Utah, Va., W. Va., and Wyoming). LLP statutes attempt to do the same thing via mandatory insurance requirements (e.g., Delaware, D.C., Utah). As explained by Hester (1994, p. LLP-11), early LLP statutes required LLPs to carry a minimum amount of insurance,

> For the purpose of satisfying judgments against the partnership or its partners based on the kind of conduct for which liability of partners is limited by statute.

However, LLP statutes requiring insurance only "if reasonably available" presents interpreters with uncertainties. Further, 15 of the 18 LLP statutes existing in 1994 omit the insurance requirement in its entirety. Inadequate capitalization, alone, rarely constitutes an immediate withdrawal of limited liability as the courts require the prevalence of one or more of the above factors as well (Fox, 1994; Kapusta and Nichols, 1994).

d. The Issue of "separateness"

The state recognizes a corporation as a legal entity separate and apart from its shareholders. The corporation, as a legal entity, can sue and be sued. The issue of separation exists when the courts determine that there is "substantial similarity in interest that the corporation no longer has a personality separate from its owners" (Fox, 1994, p. 1164). Both the LLC and the LLP are likely to fail the separate entity analysis since LLC members and LLP partners typically remain substantially involved in the intricacies of the entity. As noted above, failure to satisfy the test of separateness does not result in an automatic removal of limited liability protection. Rather, LLPs or LLCs should spend time ensuring that they meet or comply with other listed factors of analyses (i.e., fraud, formalization, and capitalization.).

Part VI: Conclusions

The business structure adopted by a sport business influences potential liability, cost structure, and managerial efficiencies. Each business structure alternative has advantages and disadvantages influencing sport business decision making. LLCs and LLPs are two recent business structure alternatives combining the flexibility and tax benefits associated with partnerships with the fund raising ability and liability protection offered to the corporation. Most sport business entrepreneurs favor the pass-through benefits associated with a partnership and limited liability. However, there is no "best" business structure for a sport entrepreneur. The size of a sport business, competition, and inherent risk of a particular product all influence the business structure alternative decision.

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Table 1

Advantages and Disadvantages of the Sole Proprietor

Primary advantages

a. Total control over all decision making
b. Revenues subject to single taxation
c. Ease of formation
d. Great flexibility
e. Reduced government and legislative restrictions
f. Individual retention of profits
g. Better able to maintain confidentiality

Primary disadvantages

a. Limited access to capital
b. Limited managerial expertise
c. Unlimited liability
d. Limited longevity

Table 2

Advantages and Disadvantages of the General Partnership

Primary advantages

a. Greater access to capital *than the s.p.*
b. Enhanced managerial talent *than the s.p.*
c. Pass-through taxation benefits

Primary disadvantages

a. Limited longevity
b. Joint and several liability
c. *Limited capital in comparison to the corporation*
d. *Limited managerial talent in comparison to the corporation*

Table 3

Advantages and Disadvantages of the Limited Partnership

Primary advantages

a. Limited partners retain limited liability
b. Ability to generate needed capital
c. Provides limited partners with a diversified portfolio
d. Limited partners retain "pass-through" tax benefits

Primary disadvantage

a. Inability of the limited partner to participate in management

Table 4

Primary Advantages and Disadvantages of the S Corporation

Primary advantages

a. Limited liability
b. Single taxation
c. Ease of raising capital
d. Ability to secure better talent
e. Avoidance of the alternative minimum tax
f. Personal service corporations incur lower tax liabilities

Primary disadvantages

a. Limited in size to 35 shareholders
b. Entity can issue only one type of stock
c. Shareholders can only be U.S. citizens or resident aliens (no partnership or corporate shareholders)
d. S corporation cannot own 80% or more of the stock of another corporation
e. Prohibits employee-shareholders from borrowing money from pension plans
f. Employee benefit deductions are limited if employee-shareholder owns less than 2% of the corporate stock

Table 5

Primary Advantages and Disadvantages of the Corporation

Primary advantages

a. Access to capital
b. Limited liability
c. Ability to secure the best managerial talent.
d. Decrease tax liabilities for small or one-person entities.
e. Dividends paid to a corporation are 70% tax-free.
f. Benefit as some favor corporate accounts

Primary disadvantages

a. Double taxation.
b. Shareholders play an inactive role in management of the firm.
c. Extensive corporate formalities.
d. Extensive government scrutiny.

Table 6

Primary Advantages and Disadvantages of the Limited Liability Corporation

Primary advantages

a. Limited liability
b. Pass-through taxation benefits
c. LLC members can include corporations and partnerships
d. Unlimited number of members
e. Ease of parent-subsidiary structures

Primary disadvantages

a. Limited precedent established due to newness
b. Conversion expense

Table 7

Primary Advantages and Disadvantages of the Limited Liability Partnership

Primary advantages

a. Pass-through tax benefits
b. Easy formation in comparison to corporation
c. Limited liability

Primary disadvantages

a. Limited precedent established due to newness
b. Conversion expense

Table 8

Public Golf Courses

	1977			1982			1987			1992		
	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E
	(percentages)			(percentages)			(percentages)			(percentages)		
SP	.28	.15	.16	.24	.13	.17	.24	.12	.14	.19	.08	.11
P	.13	.12	.29	.13	.13	.31	.11	.10	.28	.10	.12	.32
C	.59	.73	.37	.62	.74	.37	.65	.78	.34	.70	.79	.30
O	.002	.002	.33	.02	.008	.15	.005	.004	.24	.01	.01	.27

SP = sole proprietorships; P = partnerships; C = corporations; O = other.
# = number of establishments; Rev. = total revenues; R/E = revenues per establishment

Source: Census of Service Industries.

Table 9

Membership Sports and Recreation Clubs

	1977			1982			1987			1992		
	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E
	(percentages)			(percentages)			(percentages)			(percentages)		
SP	.13	.07	.12	.14	.06	.13	.14	.05	.11	.14	.05	.10
P	.07	.09	.29	.11	.13	.36	.09	.11	.42	.07	.10	.46
C	.78	.83	.25	.73	.80	.34	.76	.84	.36	.78	.85	.34
O	.008	.01	.33	.02	.01	.17	.01	.004	.11	.01	.005	.10

SP = sole proprietorships; P = partnerships; C = corporations; O = other.
# = number of establishments; Rev. = total revenues; R/E = revenues per establishment

Source: Census of Service Industries.

Table 10

Sporting Goods and Bicycle Shops

	1977			1982			1987			1992		
	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E	#	Rev.	R/E
	(percentages)			(percentages)			(percentages)			(percentages)		
SP	.42	.21	.14	.32	.14	.13	.34	.14	.08	.32	.14	.16
P	.08	.06	.21	.06	.04	.18	.06	.03	.10	.05	.03	.20
C	.50	.73	.42	.61	.83	.42	.58	.81	.27	.64	.83	.45
O	.002	.001	.22	.002	.001	.26	.008	.02	.55	.001	.001	.20

SP = sole proprietorships; P = partnerships; C = corporations; O = other.
# = number of establishments; Rev. = total revenues; R/E = revenues per establishment

Source: Census of Retail Trade.

Table 11

Physical Fitness Facilities

	1987			1992		
	#	Rev.	R/E	#	Rev.	R/E
	(percentages)			(percentages)		
SP	.21	.06	.09	.20	.05	.08
P	.09	.08	.29	.06	.08	.38
C	.69	.86	.39	.73	.86	.34
O	.003	.003	.23	.004	.004	.28

SP = sole proprietorships; P = partnerships; C = corporations; O = other.
# = number of establishments; Rev. = total revenues; R/E = revenues per establishment

Source: Census of Service Industries.

ATTENTION

In Volume 6, Number 1 of JLAS the editor failed to include an author's name. The article starting on page 52 entitled, "Compensation Discrimination and Women's Athletics: The Coaches, The Courts, and The Battle," written by Kimberly Kuehner and John Wolohan. Kimberly's name was inadvertently left off the article. Kimberly Kuehner was the lead author for the article. Her address is 109 Meadow Lane, Marshalltown, IA 50158.