Garland W. Binns, Jr.
Dover Dixon Horne PLLC
Attorneys at Law
425 West Capitol, 37th Floor
Little Rock, Arkansas 72201
Telephone: (501) 375-9151
Facsimile: (501) 372-7142
Email: gbinns@ddh-ar.com
Web Site: www.GWBinns.com

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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Banking at Wal-Mart

Although its past efforts into banking have been unsuccessful, Wal-Mart Stores, Inc. has applied to establish an industrial loan company, *i.e.*, bank, in the state of Utah for the purpose of processing electronic payments, such as credit cards and checks. In order to save on the fees that it is currently paying to insured depository institutions that have direct access to the electronic payment system, Wal-Mart needs an insured depository institution such as the industrial bank in order to originate transactions and have direct access to the electronic payment system. Most industrial loan companies became eligible for FDIC insurance with the passage of the Garn-St Germain Depository Institutions Act in 1982. Subsequently, even though Congress enacted new legislation under the Competitive Equality Banking Act in 1987 regarding banks that are subject to jurisdiction and regulation of the Federal Reserve Board under the Bank Holding Company Act, there are a number of exceptions for industrial loan companies under the definition of a “bank.” Because industrial loan companies remain one of the few types of FDIC insured depository institutions that are not subject to the Bank Holding Company Act and regulation by the Federal Reserve Board, they are attractive vehicles for non-financial companies, such as Wal-Mart, seeking to own or control a bank.

Selection of the Right Business Entity

In evaluating the risks and tax consequences of operating a business, it is necessary to select the right business entity. A business entity will generally fall in one of the categories as follows:

- Sole Proprietorship
- General Partnership
- Corporation
- Limited Liability Company

A *sole proprietorship* is a business that is operated by an individual which has no separate identity from its owner. The income and expenses of the sole proprietorship are reported on the individual tax return of the owner. The primary disadvantage of a sole proprietorship is that the owner is personally liable for the debts of the company, thus placing the owner’s entire personal assets and wealth at risk.

A *general partnership* exists when two or more co-owners engage in a trade or business. In the absence of a partnership agreement, profits are shared equally by the owners. A written partnership agreement will usually provide the manner in which profits and losses are shared by the owners. As in a sole proprietorship, the owners are personally liable for the debts of the partnership. Since the partnership is not a separate legal entity, its profits and losses are included on the individual tax returns of the owners based on their ownership of the partnership. In the absence of a partnership agreement, each owner has an equal right to participate in the management and control of the business. Another form of the general partnership is the *joint venture*, which is typically formed to undertake a specific business transaction such as in the development of a piece of real property. A variation of the general partnership is the limited partnership. In a *limited partnership*, a "general" partner manages the business, while the "limited partners" contribute capital and share in the profits. The general partner is personally liable for the debts of the partnership while the limited partners incur no liability with respect to the partnership obligations beyond their capital contributions.

A *C corporation* is a separate legal entity organized under state law which is created when the owners, known as shareholders, transfer cash or property in exchange for stock of the corporation. The profits of the corporation are taxed to both the corporation and also to the shareholders when the profits are distributed in the form of dividends. Unlike a sole proprietorship or partnership, shareholders cannot deduct any losses incurred by the corporation. The shareholders' liability is limited to the amount of their investment in the corporation. The corporation pays taxes at its own corporate income rates and files its own corporate tax returns each year. The management and control of the corporation is vested in the board of directors, who are elected by the shareholders of the corporation.

A *S corporation* is a standard corporation that has elected a special tax status with the Internal Revenue Service which eliminates the possibility of the double taxation that occurs with a C corporation. By making the S corporation election, the income and losses of the corporation are reported on the tax returns of the shareholders. There are certain restrictions on qualifying as a S corporation with the Internal Revenue Service including, but not limited to, that the corporation have only one class of stock and there be no more than 100 shareholders.

The *limited liability company*, which is generally known as a "LLC," is a business entity that has the characteristics of both partnerships and corporations by combining the corporate advantage of the limited liability with the income and losses being passed through to the owners, meaning that the LLC is taxed like a partnership or S corporation. Since the LLC is not taxed as a separate entity, the income and losses are reported on the tax returns of the owners. A LLC is owned by its members and does not have any restrictions on the number of members it can have. The members of a LLC are similar to partners in a partnership or shareholders in a corporation. The members of a LLC have the same limited personal liability provided to shareholders of a corporation. A member of a LLC will resemble shareholders in a corporation if the LLC utilizes a manager, since the members will not participate in the management of the LLC. However, if the LLC does not utilize a manager, then the members will be similar to partners in a partnership, since they will have a direct voice in decisions made by the LLC.

One of the primary reasons for choosing the corporation or the LLC as the business entity is to protect the owner's personal assets from potential liabilities that may occur in the operation of the business. Without the protection afforded by a corporation or LLC, the owners will remain personally liable for the debts of the business. In operating a business, one should carefully consider the selection of the right business entity in evaluating the risks and tax consequences.

 Comments, ideas, opinions and questions - email gbinns@ddh-ar.com - telephone (501) 375-9151 - facsimile (501) 372-7142.