# Chapter Readings, Lecture Notes, Videos and Podcasts

Read Ch 6 –Forms of Business Ownership

Chapter 6. Forms of Business Ownership

****Part 1: Learning Objectives****

1. Explain the advantages and the disadvantages of a sole proprietorship and a partnership.
2. Describe the similarities and differences of the C corporation and the S corporation.
3. Understand the characteristics of the Limited Liability Company.
4. Explain the process of creating a legal entity for a business.
5. Understand the advantages and disadvantages of buying an existing business.
6. Define the steps involved in the *right* way to buy a business.
7. Understand how the negotiation process works and identify the factors that affect it.

****Part 2: Class Instruction****

****Introduction****

The most important issues entrepreneurs should consider when they are evaluating the various forms of ownership include:

* Tax considerations
* Liability exposure
* Start-up and future capital requirements
* Control
* Managerial ability
* Business goals
* Management succession plans
* Cost of formation

The major forms of ownership discussed in this chapter include: Sole proprietorship, general partnership, limited partnership, corporation, S corporation, and limited liability company.  Refer to Figure 6.1, Forms of Business Ownership (A) Percentage of Businesses; (B) Percentage of Sales: (C) Percentage of Net Income, to see the data regarding the distribution of the percentage of each business form and the percentage of total business sales revenues illustrates the dominate forms of business ownership.

****Sole Proprietorships and Partnerships              LO 1****

****The Sole Proprietorship.****The ***sole proprietorship*** is the most popular type of ownership, defined as business owned and managed by one individual.

****The Advantages of a Proprietorship****.  Advantages of the sole proprietorship include:

* Simple to create
* Least costly form of ownership to begin
* Profit incentive
* Offers total decision-making authority
* No special legal restrictions
* Easy to discontinue

****The Disadvantages of Proprietorship.**** Disadvantages include:

* ***Unlimited personal liability*** means that the sole proprietor is personally liable for all of the business’s debts, as the owner is the business.
* Limited skills and capabilities
* Feelings of isolation
* Limited access to capital
* Lack of continuity for the business

****The Partnership.****A ***partnership*** is an association of two or more people who co-own a business for the purpose of making a profit. This association between the owners is defined by the ***partnership agreement***, a document that states in writing the terms under which the partners agree to operate and that protects each partner’s interest in the business.

If no partnership agreement exists, the Revised Uniform Partnership Act (RUPA) codifies the body of law dealing with partnerships in the United States. It specifies three key elements of a partnership, which include common ownership, how the business’s profits and losses will be shared, and the right to participate in managing the operation of the partnership.  It also sets forth the partners’ general obligations such as sharing any business losses, working without salary, settle disagreements, etc.

****The Advantages of the Partnership.****  Advantages include:

* Easy to establish
* Complementary skills
* Division of profits
* Larger pool of capital
* Ability to attract limited partners

Types of partnerships include:

* ***General partners*** – partners share in owning, operating, and managing a business. All partners have unlimited personal liability.
* ***Limited partners*** – are financial investors in a partnership, cannot participate in the day-to-day management, and have limited liability. If the business fails they only lose the money they have invested in it.
* ***Silent partners***– are not active in a business but generally are known to be members of the partnership.
* ***Dormant partners***– are neither active nor generally known to be associated with the business.
* ***Limited partnership*** – composed of at least one general partner and at least one limited partner. There is no limit on the total number of limited partners.  The general partner is treated the same as in a general partnership, while the limited partners are treated as investor.

Additional partnership advantages include: minimal governmental regulation, flexibility, and taxation.

****The Disadvantages of the Partnership****.  Disadvantages include:

* Unlimited liability of at least one partner
* Capital accumulation
* Difficulty in disposing of partnership interest
* Potential for personality and authority conflicts
* Partners are bound by the law of agency

****Limited Liability Partnerships (LLP)****.***Limited liability partnerships*** are composed of all limited partners, giving them the advantage of limited liability for the debts of the partnership.   Most states restrict LLPs to certain types of professionals, such as attorneys, physicians, dentists, and accountants.

****Consider using You Be the Consultant: “Making a Partnership Work” at this point.****

****Corporations                                                       LO 2****

The U.S. Supreme Court has defined the ***corporation*** as “an artificial being, invisible, intangible, and existing only in contemplation of the law.”  The corporation is a separate entity apart from its owners, and may engage in business, make contracts, sue and be sued, and pay taxes. This means that the owners of a corporation are not personally liable for the actions of the corporation.  However, because start-ups are so risky, lenders and other creditors often require the founders of small corporations to personally guarantee loans made to the business.  Courts ignore the limited liability shield when an entrepreneur uses corporate assets for personal reasons, fails to act in a responsible manner and creates an unwarranted level of financial risk for the stockholders, makes financial misrepresentations, or takes actions in the name of the corporation that were not authorized by the board of directors.  Refer to Table 6.1, Avoiding Legal Tangles in a Corporation.

Corporations have the power to raise large amounts of capital by selling shares of ownership to outside investors.  A ***closely held corporation*** has shares that are controlled by a relatively small number of people, and the stock is passed from one generation to the next instead of being traded on any stock exchange.  A ***publicly held corporation*** has a large number of shareholders, and its stock usually is traded on one of the large stock exchanges.

****The C Corporation.****

A C corporation is the traditional form of incorporation.  It is a separate legal entity and must pay taxes on its income at the federal level, in most states, and to some local governments as well. Before stockholders receive dividends, a C corporation must pay taxes at the corporate tax rate; then stockholders must pay taxes on the dividends they receive.  This ***double taxation*** is a distinct disadvantage of the C corporation form of ownership.  If a company intends to seek investment from venture capital or other form of private equity, it should be established as a C corporation.  Advantages of a corporation include:

* Limited liability of stockholders
* Ability to attract capital
* Ability to continue indefinitely
* Transferable ownership

Disadvantages of a corporation include:

* Cost and time involved in the incorporation process
* Double taxation
* Potential for diminished managerial incentives
* Legal requirements and regulatory red tape
* Potential loss of control by the founder(s)

****The S Corporation.****

An ***S corporation*** was established specifically for small, closely held businesses to alleviate the owners from the double taxation that occurs with a C corporation.  The S standing for “small,” is the same as any other corporation, except that they do not pay taxes on corporate income.  Income instead is passed through to the owners, just like a sole proprietorship or partnership.  Refer to Table 6.2, Tax Rate Comparison: C Corporation and S Corporation or Limited Liability Company.

The criteria for businesses seeking “S” status are that the venture must:

* Be a domestic (U.S.) corporation
* Limit shareholders to individuals, estates, and certain types of trusts
* Cannot include partnerships, corporations, or nonresident aliens as shareholders
* Not have more than 100 shareholders
* Have only one class of common stock so all shares have the same rights
* Must be an eligible corporation; certain financial institutions, insurance companies, and domestic international sales corporations are ineligible.

Advantages of an S corporation include:

* Retains all of the advantages of regular corporations
* Passes all profits/losses through to individual shareholders
* Avoids double taxation
* Avoids taxes paid on assets that have appreciated in value and are sold

Disadvantages of an S corporation include:

* Increase in individual tax rates above maximum corporate tax rate. The S corporation should follow the ***1/3, 1/3, 1/3 rule of thumb***: distribute one-third of earnings to the shareholders to cover the taxes they will owe, retain one-third of earnings to fund growth, and earmark the final one-third to pay down debt, fund debt, or distribute to the owners as a return on their investment.
* Many fringe benefits cannot be deductible business expenses

Choosing an “S” corporation wisely is important to optimize the advantages this entity offers.

****The Limited Liability Company                        LO 3****

***The Limited Liability Company (LLC)***, like an S corporation, offers its owners limited personal liability for the debts of the business, providing a significant advantage over sole proprietors and partnerships.  LLCs, however, are not subject to many of the restrictions currently imposed on S corporations and offer more flexibility than S corporations.  LLCs offer many of the advantages of both, but are not subject to the restrictions incurred by “S” corporations.  LLCs offer the tax advantage of a partnership, the legal protection of a corporation, and maximum operating flexibility. These advantages make the LLC an attractive form of ownership for smaller companies across many industries.

Creating an LLC is much like creating a corporation through establishing the ***articles of organization*** and an ***operating agreement***.

There are some disadvantages as they can be expensive to create, and may be required in some states to pay special fees.  LLCs have limited life spans, and the cost of employee benefits is not deductable as a business expense. 

****How to Create a Legal Business Entity              LO 4****

C corporations, S corporations, and LLCs can be costly and time consuming to establish and to maintain.  Many entrepreneurs hire attorneys to handle the process, but in most states entrepreneurs can complete all of the required forms themselves, but must be very cautious.  Although it is cheaper to complete the process themselves, it is not always the best idea.  This is especially true if there are multiple founders as shareholder or member agreements must be developed.

Once entrepreneurs decide to form a legal business entity, they must choose a state in which to establish the entity.  Most will choose the state in which they will operate.

Refer to Table 6.3, Characteristics of the Major Forms of Ownership.

****Buying an Existing Business                     LO 5****

The process of evaluating a potential business acquisition is standard, and requires a due diligence process that involves analyzing and evaluating an existing business.  If done correctly, this due diligence will reveal both the negative and the positive aspects of an existing business.  A prospective owner must ask several key questions before buying an existing business.

* Is it the right type of business for sale in a market in which you want to operate?
* What experience do I bring to the venture?
* What is the success potential?
* What changes are needed—and how extensive are they—to realize the full potential of the value of the business?
* What price and payment method are reasonable for you and acceptable to the seller?
* Is the seller willing to finance part of the purchase price?
* Will the company generate sufficient cash to pay for itself and leave you with a suitable rate of return on your investment?
* Should you be starting a business and building it from the group up rather than buying an existing one?

People buy businesses for different reasons. As described in Figure 6.2, Types of Business Buyers, buyers can be categorized into four areas:

1. Main street buyers
2. Corporate refugees
3. Serial entrepreneurs
4. Financial buyers

****The Advantages of Buying an Existing Business.****  Advantages include:

* A successful existing business may continue to be successful.
* An existing business may already have a superior location.
* Employees and suppliers are established. Equipment is installed and productive capacity is known.
* Inventory is in place and trade credit is established.
* A turnkey business already has operating processes in place.
* The new owner can use the experience of the previous owner.
* Easier access to financing.
* High value is possible if the current owner must sell quickly.

****Disadvantages of Buying an Existing Business.****  Disadvantages include:

* Cash requirements may be higher than if starting a new business.
* Business may be losing money.
* Paying for ill will if the previous owner used improper business behavior or unethical practices.
* Employees inherited with the business may not be suitable.
* The business location may have become/is unsatisfactory.
* Equipment and facilities may be obsolete or inefficient.
* Change and innovation are difficult to implement.
* Inventory may be outdated or obsolete.
* Accounts receivable may be worth less than face value.
* The business may be overpriced.

****The Steps in Acquiring a Business            LO 6****

Fifty to seventy-five percent of business sales that are initiated fall through.  Refer to Figure 6.3, The Acquisition Process.  There are seven steps in the process.

****Step 1: Analyze Your Skills, Abilities, and Interests.****Conduct a self-inventory to analyze your skills, abilities, and personal interests.  Sample questions include what business activities you enjoy most, which industries and markets have growth potential, what do you want to avoid, what you expect to get from the business, what you expect to put into the business, how much risk you’re willing to take, and if you’re able to turn around a struggling business.

****Step 2: Develop a List of Criteria.**** Develop a list of criteria that define the ideal business for you. Use your answers to the self-inventory to develop a list of criteria that a potential business must meet.

****Step 3: Prepare a List of Potential Candidates.****   List companies that meet your criteria.  Do not limit your search to businesses that are advertised as being for sale, as there is a ***hidden market*** of companies that might be for sale but are not advertized as such.  These hidden businesses for sale may be found listed on the Internet, through business brokers, other professionals like attorneys or bankers, industry contacts, through networking, trade associations, asking the owner of a business if he or she would like to sell, or through newspapers or trade journals.

****Step 4:  Investigate and Evaluate Potential Companies.****   Investigate and evaluate candidate businesses to determine the best one.  This due diligence process is to minimize the pitfalls and problems that will arise. This step will require patience.  Obtain answers to questions such as: what are the company’s strengths and weaknesses, what is the overall financial condition, what is the cash flow cycle, who are the major competitors, how large is the customer base, how suitable are the current employees and will they stay, what is the physical condition of the business, and what new skills must you learn to manage the business.

****Step 5: Explore Financing Options****.  Traditional lenders typically lend only a portion of the value of the assets of the business, and buyers often must search for alternative sources of funds.  Often the seller is willing to finance the sale.

****Step 6: Negotiate a Reasonable Deal with the Owner****.  The first rule is to avoid confusing price with value.  *Value* is what the business is actually worth; *price* is what they buyer agrees to pay.  Buyers and sellers seek the following:

* Buyers want the business at the lowest price, while sellers want the highest price.
* Buyers want to negotiate favorable payment terms, preferably over time. Sellers want to sever all responsibility for the company’s liabilities.
* Buyers want assurances that they are buying the business they think they are getting. Sellers want to make sure the buyer will be able to make all future payments.
* Buyers want to avoid putting the seller in a position to open a competing business. Sellers want to avoid unreasonable contract terms that might limit his or her future opportunities.
* Buyers want to minimize the amount of cash paid up front. Sellers want to maximize the cash they get from the deal, and minimize the tax burden from the sale.

****Step 7: Ensure a Smooth Transition.****  To avoid a bumpy transition, the buyer should do the following:

* Concentrate on communicating with employees to reduce uncertainty and anxiety. Be honest with employees, and share your vision for the business to increase motivation and support.
* Listen to employees as they have firsthand knowledge of the business and its strengths and weaknesses, and usually can offer suggestions for improvement.
* Consider asking the seller to serve as a consultant until the transition is complete.
* Be prepared to take action if there are problem employees.

****Negotiating the Deal                                  LO 7****

The negotiation process should not be “If you win, then I lose.”  Instead it will go much more smoothly and faster if both parties work to establish a cooperative relationship based on honesty and trust and an attitude of “we both will win.”  Both parties should examine and articulate their respective positions while trying to understand the other party’s.  A buyer should go into the negotiation with a list of objectives ranked in order of priority, and anticipate what the seller’s priorities are in order to determine where the two mesh and where they conflict.  The key is to use this analysis to look for areas of mutual benefit and use them as the foundation for the negotiation.

****Conclusion****

The entrepreneur will benefit from an intentional choice regarding the choice of business ownership. Take all the important factors into consideration – liability, taxes, capital requirements, control, managerial abilities, business goals, and a long-term succession plan. The ownership decision has far-reaching effects for both the entrepreneur and the business.