

6.3: Selecting a Form of Business Ownership

Learning Objectives

- List the important factors in choosing an organizational type
- Explain the important factors in choosing an organizational type



One of the first and most important decisions a business owner makes is selecting the organizational form under which he or she will operate. The following are some common organizational types (also called “legal structures”):

- Sole proprietorship
- General partnership
- Franchise
- Limited partnerships and limited liability partnerships (LLP)
- Limited liability company (LLC)
- C corporation
- S corporation

Each form of ownership has advantages, disadvantages, risks, and rewards that can affect the business’s chances for long-term success. The following are some of the important factors business owners should consider when selecting a form of ownership.

Cost of Start-up

Setting up a business can involve little more than printing some business cards, or it may entail hiring a corporate attorney to draft corporate charters, agreements, and articles of incorporation. As the forms of business ownership become more complex, the cost associated with establishing the business also increases. Every business owner must decide how long he/she wants to wait before getting the business up and running and also how much of his/her own money to invest.

Control vs. Responsibility

One of the primary reasons people give for wanting to start their own business is the desire to be independent and “be your own boss.” Different legal structures provide the owner with more or less control and authority. There are trade-offs in each case, though, because with autonomy and control come responsibility. For instance, if you’re the sole proprietor of a business with no employees, as a one-person show, you retain all the control, but you also have all the work and responsibility. Other forms of business (such as partnerships, for example,) may mean relinquishing some control, but, in return, the responsibility (and liability) may be spread among several principals. You’ll learn more about these trade-offs later in the module.

Profits—to Share or Not to Share

Many first-time business owners look to people like Bill Gates, Oprah Winfrey, or Ben & Jerry and aspire to their level of wealth and success. How a business’s profits are shared (or not shared) is determined by the legal structure. Some owners are willing to share the profits in exchange for assistance and support establishing and running the business. Other business owners make the conscious decision to limit the scope and nature of the business to avoid having to bring in others, thereby retaining all of the income themselves.

Taxation

When planning to start a new business, many people instinctively seek the advice of an attorney as the first step in the process. However, legal advice is not actually what’s needed initially. Instead, no matter how large or small your business is going to be, it’s

much more important to first get the advice of a seasoned tax professional, such as a CPA. The reason for this is that each form of business ownership is treated differently by the IRS and by state and local taxing authorities. Depending on the legal structure of the business, the owner may be taxed at a lower rate than someone working for a large company, or the owner might see his or her business income taxed twice, sometimes with additional speciality taxes imposed by governmental agencies. The time for a business owner to decide how heavy a tax burden he/she is willing to bear is at the start of the business, not on April 15 when taxes are due.

Entrepreneurial Ability

At some point you've probably known someone with a particular knack for something (like fixing cars or baking bread) and said, "You should start your own business!" For example, maybe you are a talented cake decorator, but does that necessarily mean you have the requisite knowledge, skills, and abilities to open and run a successful commercial or retail bakery?

It's often easier said than done. Many businesses fail despite the owner's enthusiasm and/or talent, because the owner lacks the deep knowledge and expertise needed to transform an interest or hobby into a commercial enterprise. Performing an honest and accurate appraisal of one's skills, background, and entrepreneurial abilities *before* launching a business can prevent disappointment and failure later on.

Risk Tolerance

Everyone's tolerance for risk is different. Some people enjoy the rush of skydiving and rollercoasters, while others prefer to stick to the carousel or keep their feet on the ground. In business, one's degree of risk tolerance should be compatible with the form of ownership being considered. For example, a forty-five-year old entrepreneur with dependents might seek to protect her accumulated assets (real estate, savings, retirement, etc.) and therefore select a legal structure that carries less personal financial risk. Every prospective business owner must gauge what he or she is willing to risk losing and choose a form of business accordingly.

Financing

Few business owners start a business with lottery winnings or many years' worth of savings. Many seek funding from a bank, venture capitalist, private investor, or credit union in order to get their businesses off the ground. Lenders may be one of the greatest influences on the choice of business ownership—even more decisive than the owner's preference or ambition. Since there is risk inherent in any business venture, especially start-ups, lenders often require the business to be structured in a way that best assures the repayment of funds (whether the business makes it or not). Even businesses that have been established for a long time may be forced to change their legal structure when seeking funding to expand their operations. If an owner anticipates needing funding at any point during the life of the business, selecting a form of ownership that aligns with lender requirements from the start may be a wise decision.

Continuity and Transferability

Finally, business owners need to consider if they want their business to outlive them (or carry on after they leave). If an owner is looking to start a business that can be passed on to his or her children or other family members, then the legal structure of the business is extremely important. Certain organizational types "die" with the owner, so it's crucial for the owner to decide how and whether a business will persist and/or be sold to new ownership.

These are just some of the considerations business owners must weigh when selecting a form of business ownership. Many of these issues require owners to look far into the future of their business and imagine all of the "what if's" associated with being self-employed. Although it is possible to change legal structure once the business is established, the more complex the business operations are the more complex the change will be. In some cases, the complexity of the situation can prevent the owner from making the change that's desired. Considering as many of these factors as possible from the outset can save countless hours and great expense down the road.

? Practice Questions

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In the coming sections we will explore the possible legal structures a business owner can choose and look at the advantages and disadvantages of each. We will begin with the simplest of all organizational types: the sole proprietorship.

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