Own It Your Way

Types of Business Ownership

So What?

Pete always wanted to own his own business. After college, he moved to North Carolina and started cleaning gutters. His company, Major League Gutter Cleaning, has doubled its business each year for the past five years. Business is so good that Pete is struggling to keep up with all his clients. He knows it's time to either hire an employee or take on a partner. If he hires someone, he'll remain in total control of his company. But if he takes on a partner, he'll have someone with whom to share the risks and expenses.

Why is it important to understand different forms of business ownership? Like Pete, you may own your own business someday. When it comes time to establish legal ownership or expand your operations, you'll need to know your options. The ownership form you choose affects the way you conduct your business activities as well as your risks and responsibilities. You'll want to choose a form that suits your business's unique needs and objectives. Read on to explore the different ways you can establish business ownership.

Make It Your Own

Types of business ownership

What would you do if you could start your own business? Whether you want to produce movies, design video games, or even start a new airline, one thing is true—you'll have to establish a legal form of ownership for your business. The way you structure your company depends on your personal circumstances, your financial needs, and the type of business you are starting. Choosing an appropriate structure is very important because it affects issues such as taxation, liability, and ownership control.

The United States is a **private enterprise system**, or an economic system in which individuals and groups, rather than the government, own or control the means of production. This has resulted in millions of businesses operating in the United States today. Most of these businesses operate under one of four forms of business ownership:

- Sole proprietorship
- Partnership
- Corporation
- Hybrid structure

As businesses grow, their needs sometimes change. Owners might decide to alter the ownership form to meet new company objectives. But before deciding what is best for a business, you must learn how each form of ownership works.

Objectives

A. Explain the most common forms of business ownership in a private enterprise system.

B. Discuss business startup strategies.

Flying solo

A **sole proprietorship** is owned by one person who assumes all the profits and risks from the business. By taking all the risks, a sole proprietor experiences **unlimited liability**—meaning any debts that the business owes can be collected from the owner's personal **assets**, or belongings. In other words, if the owner cannot pay business-related debts, bill collectors can take their car, boat, or home as payment.

Over 70% of the businesses in the United States are sole proprietorships and typically employ fewer than 50 people. This form of ownership is often chosen for businesses that can easily be managed by the owner or someone the owner hires. Sole proprietorships are often found in small, local, and/or home-based businesses. Consider the accountant who lives down the street from you and prepares taxes for people in their own home. Their business is a sole proprietorship.

▲ The majority of businesses today are sole proprietorships.

Most business owners do not need to address complicated legal issues within a sole proprietorship. However, depending on the type of business, the owner might need to obtain permits or licenses to operate equipment, machinery, vehicles, etc. Some business owners, such as hairstylists, must be certified and licensed in the state in which they work. For the most part, though, sole proprietorships receive minimal government intervention. Business and individual taxes are not separated, and owners claim business taxes on their personal income tax returns each year.

In many cases, sole proprietors do not need a great deal of capital to get started. Some may only pay for business cards to get their business going. If sole proprietors need startup funds, however, they can obtain them from private investors or bank loans (provided they meet lender qualifications). Some may just use personal savings or cut back on personal expenses to get their business off the ground.

It takes two

Another ownership option to consider is a **partnership**—a business that is owned by two or more people. Often, the purpose of forming a partnership is to combine **capital** (money), experience, and/or abilities. In a partnership, the partners share both the profits and the risk of loss. They decide what each owner will contribute to the business and what each will get out of it. Let's say you form a partnership with your brother and open an art gallery. He provides the startup funds for rent, utilities, and advertising, and you provide the expertise to choose the artwork and run day-to-day operations. By partnering together, you form a business that neither of you could start alone.

▲ Partnerships combine capital, experience, and abilities to form a business neither owner could start alone.

There are two basic types of partnerships. In the most common form, a **general partnership**, each partner has unlimited liability. Just as in a sole proprietorship, business debts can be paid by taking some or all of each partner's personal assets. In a **limited partnership**, on the other hand, at least one partner has **limited liability** and a general partner has unlimited liability. A limited partner's amount of financial responsibility is limited to the amount the partner invested. For example, if a limited partner invested $5,000 in their business, that is all they would lose if the company went out of business. Setting up a limited partnership is a little more complicated than establishing a general partnership because the government requires partners to comply with several different rules and restrictions. And, the laws governing business partnerships vary from state to state.

Can you incorporate?

What do iPads, Hershey's Kisses, and Reebok shoes have in common? All of these products are produced by corporations. The U.S. Supreme Court defines a **corporation** as an "artificial being, invisible, intangible, and existing only in contemplation of law." A corporation functions independently of its owners and is treated as a person with legal rights, duties, and powers.

▲ A corporation functions independently of its owners and is treated as a person with legal rights, duties, and powers.

Because the corporation is considered separate from its owners, the owners are not liable for the company's actions, and their personal property cannot be taken to pay outstanding debts. Owners are only liable for the amount they invested in the company. A corporation can:

- Borrow and lend money
- Buy and sell goods
- Make contracts
- Sue or be sued
- Have an unlimited life span

To be an owner of a corporation, a person purchases shares of stock and becomes a **stockholder** (or **shareholder**). The more shares of stock a person owns, the more control the person has over the business.

The corporation form of ownership is suitable for almost any type of business. It is often used for businesses that require large amounts of capital (e.g., airlines and manufacturing). Businesses with uncertain futures, such as new magazine publishers or entertainment ventures, are also well suited to be corporations. In the United States, corporations are in the minority as a form of business ownership, but they generate the majority of sales. The complex nature of corporations subjects them to more government regulation than sole proprietorships or partnerships.

Corporations are governed by a **board of directors**, which consists of people, sometimes stockholders, who make decisions about the activities of the business. The company's officers (e.g., president, chief financial officer) execute these decisions and run the day-to-day aspects of the business.

Get a better understanding of corporations with this video from Investopedia: https://www.investopedia.com/video/play/corporation-0/.

Types of corporations

Corporations are generally established as one of four types:

- Private (or close)
- "C"
- "S"
- Nonprofit

The type of corporation determines how the business is taxed by the government and which legal guidelines it must follow.

A **private (or close) corporation** does not offer shares for sale to the general public, meaning that it might have just a few shareholders. In many cases, the shareholders also operate and manage the business. A private corporation is usually not required to make its financial activities public, but for tax reasons, it must prepare reports for the state in which it operates. A private corporation is taxed by the government in two ways. First, it is taxed on the profits made by the company itself. Second, the shareholders are taxed on the **dividends** they earn on their investments. This is often called **dual (or double) taxation**.

▲ Private (or close) corporations are subject to dual taxation.

A **"C" corporation** can sell unlimited shares of stock to the general public—meaning there may be unlimited stockholders in just one company. C corporations, also known as **public corporations**, are subject to more government regulation and taxation than other forms of business ownership. In addition, federal law mandates that C corporations provide financial information (e.g., earnings, assets, debts) to the public. This information is outlined in a formal document called an **annual report**. C corporations, like private corporations, are subject to dual taxation.

A **subchapter "S" corporation** carries the same liability protection of a corporation, but it is taxed as a partnership to help smaller businesses avoid dual taxation. This saves the owners a lot of money in taxes. To qualify as an S corporation, a company must have 100 or fewer shareholders and adhere to a number of other government policies.

A **nonprofit (or not-for-profit) corporation** operates to accomplish a specific mission—other than to make a profit. Generally, the purpose of the organization is to help society, and income is used to fund programs and cover operational expenses. Institutions that are charitable, educational, religious, or scientific in nature are usually established as nonprofit corporations. The American Red Cross defines its purpose as being "to prevent and alleviate human suffering in the face of emergencies by mobilizing the power of volunteers and the generosity of donors."

To accomplish its mission, the American Red Cross provides community services to help those in need, organizes blood drives, and administers relief programs. Because nonprofit organizations are established to benefit society, they are generally not taxed by the federal government. Many nonprofits rely on donations and grants for funding.

▲ Because nonprofit corporations exist to benefit society, they are generally not taxed by the federal government.

For more information on choosing the right business structure, check out this article from the U.S. Chamber of Commerce: https://www.uschamber.com/co/start/startup/business-structure-guide.

Ready, set, grow

There are three ways that corporations can grow once they've been established. The first is through a **merger**, which occurs when two businesses combine to form one company. This usually happens when a larger company purchases a smaller company (referred to as an **acquisition**).

▲ Corporations can grow through mergers, consolidations, and expansions.

Another way a corporation can grow is through **consolidation**, or the act of acquiring many smaller companies. An example of consolidation can be seen when one large bank buys several smaller banks.

Lastly, corporations can grow through **expansion**. A company may want to expand its operations (e.g., adding a new product line or building a new facility). To do so, the company will need to obtain more capital by selling more shares of stock, reinvesting profits back into itself, or obtaining bank loans, donations, and/or grants.

The best of both worlds

Another unique type of business ownership, a **hybrid structure**, allows owners (or members) to enjoy the advantages of corporations *and* either sole proprietorships or partnerships. Depending on the number of owners, a hybrid business can be structured in one of two forms—a **limited liability partnership (LLP)** or a **limited liability company (LLC)**. Members determine how the company is managed and how profits are shared.

Characteristics of hybrid business structures can include:

- Limited liability—Personal assets cannot be taken to pay company debts.
- Limited life—Most states require that the company dissolve after a certain amount of time and/or upon the death, retirement, or resignation of an owner.
- Limited taxation—Taxes are claimed only on individual members' personal income tax returns.
- Unlimited owners/partners—Hybrid structures can have as many members as desired.

Many professional service businesses (e.g., doctors' offices, law offices, accounting firms) structure ownership as LLPs. This form of ownership protects innocent partners from the malpractice of other partners. For example, it protects the other partners in a doctor's office if a doctor in the practice is sued by a patient.

Although LLCs typically only require one owner, laws vary by state; therefore, many LLCs have at least two owners. Like general partnerships, LLCs should develop detailed agreements, or **operating agreements**, specifying each member's role in the company. LLCs are suitable for most types of businesses.

Summary

Every business must establish a legal form of ownership. The four common types of business ownership are sole proprietorship (one owner), partnership (two or more owners), corporation (owned by stockholders), and hybrid structure (combination of forms). Business owners must learn about these forms of ownership to decide which is best suited for their company.

TOTAL RECALL

1. What is a sole proprietorship?
2. What is a partnership?
3. Name two types of partnerships.
4. What is a corporation?
5. Name four types of corporations.
6. In what ways do corporations grow?
7. What is a hybrid structure?

The Gray Zone

When a business decides to incorporate as a public (or open) corporation, it offers shares to the public in an IPO, or initial public offering. There are several laws and regulations regarding IPOs; however, companies often find ways to make IPOs work to their advantage, even if it seems unfair. For example, a company might offer shares for sale at $10,000 per share or restrict potential investors from buying in unless they purchase a certain number of shares. In essence, these IPOs shut out smaller investors to make shares available only to wealthier individuals or institutional investors who are investing for their clients. Although this is not illegal, many people consider it to be unethical. What do you think?

Explore Your Options

Methods of business ownership

You can start a business by yourself or with others who provide needed skills and/or funds. Another option for starting a business is to act as an agent to an existing company. In other words, you'll find many ownership opportunities with existing companies through franchising, multi-level marketing, licensing, and developing joint ventures. By exploring these methods of ownership, you can decide which strategy is right for you.

Find out about franchising

Did you know that you can own your own Planet Fitness or Chick-fil-A? **Franchising** is a method of distributing recognized goods and services through a legal agreement between two parties. The **franchisor** is the seller or parent company who owns the company name or trademark rights. The **franchisee** acquires the rights to operate the business using the franchisor's name. For a prospective business owner, purchasing a **franchise** can be a desirable option because the product has an established brand and reputation.

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▲ Franchises are popular because the business already has an established brand and reputation.

To own a franchise, you must first sign a franchise agreement and pay an initial franchise fee. Fee amounts range anywhere from thousands to hundreds of thousands of dollars. As a franchisee, you are responsible for costs related to facility construction, leasing, equipment, insurance, and legal fees. You might also pay a royalty fee to the franchisor based on a percentage of your profits. In addition, you might pay fees to cover advertising expenses. As you can see, starting a franchise can be expensive, but it has the potential to be very profitable in the long run.

Sometimes, the franchisor establishes a relationship with another person or firm, known as a **master licensee**, who helps find franchisees in a particular region. Depending on the terms established with the franchisor, the master licensee may support franchises in the form of training or warehousing. Land developers and others often purchase franchise rights from a business and open several outlets in a specific area. This type of multi-unit business ownership is a growing trend in the business world.

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Discover the ins and outs of franchising in this video: https://www.youtube.com/watch?v=8UsT8OzfiVI.

Franchises can take two basic forms: business-format franchises and product trade-name franchises.

Business-format franchise. This franchise arrangement is usually available to anyone who has the capital to invest. It requires a close and continuous working relationship between franchisors and franchisees. Franchisors often provide training, financial guidance, and supply channels for franchisees. In turn, franchisees benefit from their franchisor's national advertising programs since they operate under the same trade name. This reduces the franchisees' risk of business failure. On the flip side, franchisees are often limited to offering specific goods and services, using certain vendors, operating at certain hours, and presenting certain appearances. Business-format franchises can be found in almost any industry.

Within the business-format franchise, **piggyback franchising** has become popular. This is a form of ownership in which a retail franchise operates within the facilities of another store, often referred to as the host. For example, a Walmart might host a McDonald's or Subway franchise. This arrangement benefits both the franchisee and the host. The host increases its product line, while the franchisee has access to the host's customers.

Product trade-name franchise. This is an independent sales relationship between a supplier (franchisor) and a dealer (franchisee) to stock and sell a specific or exclusive line of products. Some of the major characteristics of a product trade-name franchise include the following:

- Products are usually bought on consignment or straight from the supplier/manufacturer.
- The name of the business is chosen by the franchisee.
- The franchisee usually must have a great deal of experience and financial ability before the franchisor will agree to the arrangement.

▲ Krieger Ford is an example of a product trade-name franchise in Columbus, Ohio.

Product trade-name franchisees are commonly referred to as **dealerships** or **exclusive distributorships**. They are often used in the automobile, large appliance, soft drink, and petroleum product industries. Think about your local Ford dealership. The business name may be something like Sam Roberts Ford—Sam Roberts is the franchisee, and Ford is the franchisor.

On the level

Multi-level marketing businesses have experienced tremendous growth in the past 30 years. This option refers to a business that pays **commissions** on sales earned to people at two or more levels. The sales representatives (distributors) usually work independently of the company, selling products and persuading others to sell them as well. The representatives receive payouts from the sales of the people under them. Characteristics of *legitimate* multi-level marketing businesses include the following:

- People become distributors because they have used the product and liked it.
- Most distributors are home-based and offer flexible scheduling.
- Most distributors can get started for very little money, which generally covers the cost of instructions, samples, and promotional materials.
- Commission and bonus structures differ between companies. Some companies offer incentives or prizes for attaining set sales goals.
- Distributors determine their income by the amount of time and energy they put into developing their business contacts.

Some successful multi-level marketing ventures are Beachbody, Mary Kay cosmetics, Pampered Chef kitchen products, and Young Living essential oils.

Before you get involved in multi-level marketing distribution, be sure to examine the company very carefully. Unfortunately, there are many **pyramid schemes** that operate illegally. Typically, these schemes require potential members to pay a large fee up front. Most of the emphasis is on recruiting new members in order to collect more investment fees. Very little emphasis is placed on product attributes or quality. Always check out a company with the **Better Business Bureau** or Direct Selling Association before becoming involved with it.

Do you know the difference between legitimate multi-level marketing businesses and pyramid schemes? You will after watching the video "Multi-Level Marketing" at https://www.investopedia.com/video/play/multi-level-marketing/.

Got a license for that?

Licensing refers to an owner's authorization or permission for another entity to use trademarked, copyrighted, or patented material for a specific activity, during a specific time period, for the profit of both parties. The **licensor** is the owner of the material, and the **licensee** is the buyer.

In many licensing agreements, the licensee pays **royalties**, or a percentage of the profits, to the licensor in addition to an initial licensing fee. Because terms vary and each situation is unique, you should consult a lawyer to develop licensing agreements.

These agreements are usually very specific, and improper use of licensed material could result in a lawsuit. Businesses and individuals grant licenses for many things, including:

- Technological information
- Intellectual information (e.g., research findings)
- Industrial processes or methods
- Formulas or recipes
- Recognized brands, names, or logos
- Music and art
- Inventions

As a business owner, you may be the licensee or the licensor. Perhaps you have a great product and want to use your favorite professional sports team logo on the item. In this case, you are the licensee because you must receive permission to use the logo. If you have developed an invention or process that someone else can manufacture or distribute, you are the licensor.

Adventures in joint ventures

Joint ventures, or strategic alliances, occur when two or more businesses enter into a relationship by combining complementary resources such as technology, skills, capital, or distribution channels for the benefit of all parties. The relationship is usually short-term and involves a single project or transaction. A limousine service, for example, might partner with a local television station for a year, providing free transportation for the station's guests in exchange for free on-air advertising.

Joint ventures are becoming a popular way to expand businesses, help them reach new target markets, and develop new profit centers for less money. This type of business strategy can work at all levels—from large corporations to sole proprietorships. This is a popular strategy in real estate development and in businesses that want to expand internationally.

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To learn more about joint ventures, check out Jean Murray's article "What Is a Joint Venture" at https://www.thebalancesmb.com/what-is-a-joint-venture-and-how-does-it-work-397540.

As you can see, there are many ways to get started in business ownership. Understanding your options and knowing what works for you is one of the first steps to business success!

Summary

You can start a business by acting as an agent to an existing company. Your options include franchising, multi-level marketing, licensing, and developing joint ventures. Franchising is a method of distributing recognized goods and services through a legal agreement between two parties. Multi-level marketing refers to a business that pays commissions on sales earned to people at two or more levels. Licensing refers to an owner's authorization for another entity to use trademarked, copyrighted, or patented material for the profit of both parties. Joint ventures occur when two or more businesses enter into a relationship by combining complementary resources for the benefit of all parties.

Make It Pay!

Think of the businesses in your town. Name one example of each of the following:

- Sole proprietorship
- Partnership
- Corporation
- Nonprofit corporation
- Franchise

Which of these types of businesses would you like to own? Why?

TOTAL RECALL

1. What are franchises?
2. Name two types of franchises.
3. What is multi-level marketing?
4. What is licensing?
5. What are joint ventures?