

APPROACHES TO OWNING & STRUCTURING YOUR BUSINESS

A. THREE APPROACHES TO OWNING YOUR OWN BUSINESS

Introduction

Now that you've decided to own your own business, it's time to move on to the next decision – how you should get into business. There are essentially three ways to get into your own business:

- (1) Buy an existing business.
- (2) Buy a franchise.
- (3) Start a new business from scratch.

Each approach has different pros and cons and your choice of approach will be determined by a variety of business and personal considerations.

Each of these three alternatives is addressed in the following sections. During your review of each, consider which of the cited advantages/disadvantages are important to you and which ones are important factors in the industry you are considering.

Information Sources

The following website has excellent information on these subjects:

<http://www.sbtadc.org/pdf/startup.pdf>

Buy An Existing Business

Advantages

1. The business has already gone through the difficult start-up stage and is more likely to succeed.
2. The business is ongoing and has a reputation and relationships with customers and suppliers.
3. It will probably be easier to secure financing due to the established track record. Even if the business has had little success, it may be easier to get financing if you can show how you will be able to make it more successful.
4. In many cases, it will be possible to negotiate with the seller and have them provide at least a portion of the financing required for the purchase.

Disadvantages

1. It will probably be more expensive to buy a business than to start your own because you will need to pay the seller for the so-called “goodwill” they have built in the market, in the form of name recognition and relationships with customers and suppliers. As a result, an existing business will usually be more expensive than a startup and, therefore, will require more capital.
2. There may not be any reasonably attractive businesses for sale in the industry you are seeking to enter. As a result, you may have to wait until a company comes onto the market or abandon this approach (if time is of the essence).

Information Sources

Internet: Search under “businesses for sale.”

Newspapers: Look under “Business Opportunities.”

Business Brokers

Buy A Franchise

Advantages of Franchises

1. A reputable franchise will represent a business that has already proven successful in other locations, so the risk of failure and the degree of trial-and-error is reduced.
2. The franchisor may be willing to finance all or part of the purchase price of the franchise.
3. You will be acquiring a number of valuable intangible assets:
 - a. name/brand recognition
 - b. a proven success formula
 - c. tested operating procedures, including quality control and cash management
 - d. regional or national advertising and promotions
4. There should be a complete start-up plan to get into business more quickly than a startup business. It can be a much faster track to success.
5. A good franchise will protect you against competition from other company franchises within some specified area, thereby somewhat reducing competition.
6. Some level of ongoing support will be available from the franchisor.
7. The amount of legal and accounting support required may be lessened because the franchisor will already have their side of the transaction standardized.
8. The franchisor will often have favorable purchase agreements with suppliers due to high volumes.
9. The franchisor will provide management training, which is particularly valuable if you lack the necessary experience. They may also provide training programs for your new employees.

Disadvantages of Franchises

1. A franchise will be relatively expensive initially, as well as requiring some level of "royalty" payments on an ongoing basis thereafter.
2. A franchise may also impose additional ongoing costs for advertising and promotions.
3. In most franchises, you will be restricted, by covenants in the franchise agreement, in the degree of uniqueness or creativity you can apply to the business.
4. Often, the franchisor has veto power over transfer or sale of your interest in the franchise.
5. Highly successful franchises require very large investments that may be out of reach for most entrepreneurs.

Information Sources

Internet: The following websites are good sources of information:

<http://www.franchise.com/>

<http://www.franchiseregistry.com/> (an SBA site)

Start A New Business From Scratch

Advantages

1. You can form the business and run it however you wish (within legal and other restrictions).
2. The initial startup costs will probably be lower than other approaches because you are not buying any goodwill or brand name recognition.
3. There will be no negotiations with third parties, so establishing the business is generally simpler than buying an existing business.
4. There are no geographic restrictions, so you can locate the business wherever you want.
5. You don't have to wait for an existing business or franchise to become available.

Disadvantages

1. You are on your own, without assistance from a seller or franchisor.
2. You will have to get the business through the difficult, risky startup stage.
3. You will have to arrange all of your own financing.
4. You will have to learn many strategies and processes by trial-and-error, which may be time and energy consuming and costly.
5. It will take an extended period of time to get the business started and fully operational.
6. Financing may be more difficult to obtain due to the lack of a track record.
7. You will need to establish your own name recognition.
8. Without a track record it will be more difficult to project revenue, expenses, cash flow and profits.

B. FORMS OF LEGAL STRUCTURE

There are several optional forms of legal business structure to consider. Selection of the right structure involves consideration of income taxes, estate planning, available capital and the number of individuals who will be active in the business. You should consult with an attorney and a CPA to determine which business structure is best for you.

Sole Proprietorship

A sole proprietorship is a business owned independently by one person. The business is considered an extension of the owner, not a separate entity.

Advantages

- Simplest form to establish and operate.
- Limited to one owner.
- Profit flows directly to owner's individual income tax return.
- Owner has full authority and responsibility for business.

Disadvantages

- Ability to raise capital will be heavily dependent on owner's credit history.
- Continuity of business can be disrupted by illness or death of owner.

Partnership

A partnership is a legally recognized entity owned by two or more people, who agree to contribute money, labor, property, or skills and then share in the profits, losses and management decisions of the business. Most entrepreneurs will utilize a General Partnership, wherein each partner is jointly and severely liable for all debts, taxes and other claims against the partnership.

Advantages

- Simplest form of business for two or more owners.
- Minimal formal documentation is required, although written agreements are recommended.
- Profits and losses flow directly, on prorata basis, to partners' individual tax returns.
- Increases the pool of tangible assets (e.g., money and equipment) and intangible assets (e.g., skills) for the business.

Disadvantages

- Partners are jointly and severely liable for all debts and actions of the business.
- Unless otherwise provided, partnership dissolves with withdrawal of a partner.
- Can be very difficult and/or expensive to remove or add partners.

C Corporation

A corporation is a legal entity that exists separately from the individuals who own and manage it. Corporations can acquire assets, incur debt, pay taxes, enter into contracts, issue shares of ownership, and have perpetual existence.

Articles of Incorporation must be filed with the Secretary of State's office. These articles define the business structure, as well as its purpose, authorized shares and organization of the board of directors. It is the responsibility of the board of directors to create by-laws and oversee major corporate policies and practices.

Advantages

- Limits personal liability of the owners as individuals.
- Shares are readily transferable.
- There is a continuity of existence of the business.
- Easiest form of business for raising capital, both debt and equity.
- Owners have no individual tax liability for corporate profits/losses.

Disadvantages

- Most costly in terms of formation requirements.
- Most formalities involved establishing and managing business.
- Subject to income, real estate, personal property and franchise taxes.
- Potentially subject to double or triple taxation (salaries, corporate profits and dividends).

S Corporation

When a business is incorporated, it is automatically classified as a C Corporation by the IRS. Board of Directors approval is required and a form must be submitted to the IRS, within 75 days of incorporation, in order to change the status to an S Corporation.

An S corporation is a legal entity that exists separately from the individuals who own and manage it. It can acquire assets, incur debt, pay taxes, enter into contracts, issue shares of ownership, and have perpetual existence.

Articles of Incorporation must be filed with the Secretary of State's office. These articles define the business structure, as well as its purpose, authorized shares and organization of the board of directors. It is the responsibility of the board of directors to create by-laws and oversee major corporate policies and practices.

There are several requirements for a business to qualify as an S corporation:

1. Must be a domestic corporation.
2. Maximum of 75 shareholders (owners); husband and wife may qualify as one shareholder if shares are purchased jointly.

3. All shares must be owned by U.S. citizens or resident aliens.
4. No corporations as shareholders; must be individuals, estates or certain types of trusts.
5. Only one class of stock can be issued.

Advantages

- Limited personal liability for owners.
- All profits and losses flow directly to owners' individual tax returns, on prorata basis.
- Unlimited life of business, separate from owners.
- No restrictions on transferability rights for shares.

Disadvantages

- Limited to 75 owners.
- Limited to citizens and resident aliens.
- No corporations as stockholders.
- Cannot be a member of an affiliated group of companies.

Limited Liability Company (LLC)

A limited liability company has a combination of partnership and S corporation characteristics. It has the tax characteristics of a partnership, while having the limited liability characteristic of corporations. It is considered a separate legal entity and is formed by filing Articles of Organization with the Secretary of State; these articles must be submitted by two or more owners. Owners are referred to as "members."

Advantages

- Unlimited number of shareholders.
- Profits and losses flow directly to owners' individual tax returns, on prorata basis.
- Members have management control without personal liability risk.
- Members can be individuals, partnerships, trusts, corporations or other LLCs.
- Memberships are transferable.
- Both debt and capital raising options are available.
- Avoids some of the restrictions of S corporations.

Disadvantages

- Some cost and time involved in establishing and maintaining organization.
- Requires at least two members.
- Finite existence (30 or fewer years).
- Lack of extensive legal precedence re taxation and other issues.

The table that follows provides a summary overview of the optional forms of organization, highlighting the characteristics and most important considerations relevant to each.