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How Do Firms Choose Legal Form of Organization?

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Purpose

Firms choose their legal form of organization (LFO) at start-up, and this choice has future tax, legal and financial liability implications. The choice of LFO and prevalence and reasons for switching has received scant attention, most likely because of a dearth of information. Analysis of LFO at start-up is needed because the costs associated with switching LFO as the firm ages are not minimal.

Overall Findings

Only one in three firms begins operations as a proprietorship, while almost as many begin as limited-liability companies (LLC) and corporations. The choice of LFO is relatively stable over a firm's first four years; only about one in ten changed form during the four years studied. This finding generally contradicts the widely held life-cycle theory of firm organization, namely that firms begin in the simplest forms then change form as they grow, add complexity, and require financing. When changes occur, they tend to be to the more complex LFOs such as corporations and conducted by more complex firms, such as firms with larger employment sizes or firms that offer complex employee benefit plans.

Highlights

- A firm is more likely to choose a more complex LFO at start-up when the firm is more complex (proxied by employment size, offering more complex employee benefits, and offering trade credit). A more complex initial LFO also is more likely when the firm is more highly leveraged and when its primary owner is more educated; it is less likely when the firm is more profitable, has more tangible assets, uses personal loans for firm financing, and when its primary owner is female.
- Changing an LFO is a relatively rare event. Of the 3,987 firm that made it through the fourth follow-up survey, 359 firms changed LFO at some point during the period of analysis.
- Firms initially organized as LLCs and partnerships are more likely to change LFO than are proprietorships and C corporations.
- Firms increasing employment or moving from a residence to a rented or purchased space are more likely to change LFO, as are smaller and more profitable firms.
- Firms that experience a change in the number of owners, a decrease in the ownership by the primary owner, or a change in industry are more likely to change LFO.
- The likelihood of changes to legal form declines each year a firm ages (and by more than can be explained by attrition to the sample). A possible explanation is that the longer a firm exists in a certain legal form, the more difficult it is to unwind the LFO and start under a different one.

Scope and Methodology

The Kauffman Firm Survey (KFS) was used as the base data for the study. The KFS annually tracks a panel of 4,928 businesses started in 2004. The data is weighted to account for an unbalanced sample. (Because of non-response and closing businesses, the panel decreases over time.) As of year-end 2010, four years of data was available, up to 2008. Using firm and owner characteristics, econometric models were used to identify the determinants of initial LFO choice and the determinants of switching LFO.

This report was peer reviewed consistent with the Office of Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at **advocacy@sba.gov** or (202) 205-6533.

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