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LETTER FROM THE EDITOR

Welcome to the *Entrepreneurial Executive*. We are confident that this volume continues our practice of bringing you interesting, insightful and useful articles by entrepreneurs and scholars.

The *EE* is an official journal of the Academy of Entrepreneurship®, a non-profit association of scholars and practitioners whose purpose is to advance the knowledge, understanding, and teaching of entrepreneurship throughout the world. It is our objective to expand the role of the *EE*, and to broaden its outreach. We are interested in publishing articles of practical interest to entrepreneurs and entrepreneurial scholars, alike. Consequently, we solicit manuscripts from both groups.

The *Entrepreneurial Executive* is funded by the proceeds of membership dues and conference registration fees at Academy of Entrepreneurship® and Allied Academies meetings. We do not receive funding support from any university or agency. We encourage readers to become members of the Academy and to attend conference meetings in the spring and the fall. Upcoming conferences are announced on the Allied Academies home page: www.alliedacademies.org, as well as information about the organization, its affiliates and its journals. In addition, instructions for submitting manuscripts are displayed on the home page.

The manuscripts contained in this issue were double blind reviewed by the Editorial Board members. Our acceptance rate in this issue conforms to our editorial policy of less than 25%.

James W. Carland
JoAnn C. Carland
Carland College

ENVIRONMENTAL SCANNING AND ORGANIZATIONAL LEARNING IN ENTREPRENEURIAL VENTURES

Thaddeus McEwen, North Carolina A&T State University

ABSTRACT

Because of increased globalization, rapid technological changes, and increased competition, entrepreneurs are facing new and unexpected challenges. These changes have increased the quality and quantity of information needed for decision making.

To meet this need and to obtain up-to-date information for decision making, entrepreneurs must increasingly acquire and use information from outside the organization. One way of acquiring and using outside information is through environmental scanning. This paper presents a model that focuses on environmental scanning as a primary mode of learning that enhances the entrepreneurs' knowledge and business success. The model examines how information is collected from the external environment, what organizational learning occurs, and how the organizational learning leads to improved problem-solving, strategic planning, and entrepreneurial success. Implications for entrepreneurship education and for practicing entrepreneurs are also presented.

INTRODUCTION

Entrepreneurs' knowledge is critical to building sustainable competitive advantage in the 21st century (Lerner and Almor, 2002; Anand, Glick, and Manz, 2002). Because of increased globalization, rapid technological changes, and increased competition, entrepreneurs are facing new and unexpected challenges. These changes have significantly increased the quality and quantity of information that entrepreneurs must consider when making decisions. Entrepreneurs, therefore, must process and learn from the information, and use the new knowledge for improved decision making. "New knowledge is the key resource for creating a sustainable competitive advantage." (Inkpen, 1998, p. 69). Today, more than ever, competitive advantage resides in the capabilities i. e. expertise and skills that the entrepreneurs bring to the critical activities of the venture (Rastogi, 2000).

Despite the importance of the entrepreneurs' knowledge to new venture success, many are faced with a capability gap because of the discrepancy between their current knowledge and the information that is relevant to the current business environment. To deal with this capability gap and to have the most up-to-date information for decision making, entrepreneurs must increasingly acquire information from outside the organization. One way of acquiring and using outside information is through environmental scanning.

Most studies on environmental scanning were done with large organizations (Lang, Calantone, and Gudmundson, (1997), while those done with small firms focused mainly on scanning practices (Gudmundson, Tower, and Hartman, 2001). The lack of conceptual work on the relationship among environmental scanning, organizational learning, and entrepreneurial success is surprising. Scanning allows the entrepreneur to learn from the environment; and individual and organizational learning enhance the entrepreneur’s' knowledge, and contributes to the firm’s success. The purpose of this paper is to contribute to the discussion by examining the role of entrepreneurs environmental scanning and organizational learning in entrepreneurial success.

The paper presents a conceptual model that examines (a) how entrepreneurs gather information from the external environment – environmental scanning behavior, (b) how the information gathered is interpreted to create new knowledge –Interpretation, (c) what organizational learning occurs – organizational learning, and (d) how organizational learning leads to improved problem solving, strategic planning, and ultimately to entrepreneurial success. The model provides a conceptual framework to empirically test the relationship among environmental-scanning, organizational learning, and venture success.

There have been a few attempts made to shed new light on environmental scanning and related issues by means of organizational learning. Grant (1996) saw knowledge integration as a core competence in dynamic environments, and Drejer (2005) used learning to expand what we know about innovation in hyper-competitive environments. However, there has been no direct attempt at combining organizational learning and environmental scanning.

The need for this model is also supported by several researchers who have argued that gaining insights into entrepreneurs' environmental scanning behavior will add to the understanding of entrepreneurial behavior and therefore have implications for advising prospective entrepreneurs (Lang, Calantone, and Gudmundson, (1997). This article attempts to fill a need in the literature by presenting a model that links environmental scanning , organizational learning, and entrepreneurial success.

CONCEPT OF ENVIRONMENTAL SCANNING

In his ground-breaking work on environmental scanning, Aguilar (1967) defined the concept as “the way in which management gathers relevant information about events occurring outside the company in order to guide the company’s future course of action." It is the search to identify trends that create business opportunities and pose challenges to the continued success of the organization (Costa and Teare, 1994). According to Pearce, Chapman, and David, (1982), environmental scanning is "the radar that informs the pilot of conditions which are likely to be encountered."

Environmental scanning is also more than gathering information. It is the process of using environmental information in decision making (Lester and Waters, 1989). It is a means of improving the organizational ability to deal with a rapidly changing environment (Jain, 1984). The external environment of the firm refers to both its task environment (competition, customers and suppliers), and general environment (economic, regulatory, technological, and socio-cultural factors).

For the purpose of this paper, scanning is the way entrepreneurs learn from the environment and use the new knowledge for problem solving and strategic planning. Scanning includes both looking for specific information (searching) as well as looking at information that could impact the firm (viewing). It could range from a casual conversation or a chance observation of an angry customer, to a formal market research program.

There are different types of scanning. Aguilar (1967) described scanning as undirected viewing, conditioned viewing, informal search, and formal search. Fahey, King, and Narayanan (1981) viewed scanning as irregular, periodic, and continuous, while for Jain (1984) scanning is classified as primitive, adhoc, reactive, and proactive. Morrison, Renfro and Boucher (1984), simplified the different types of scanning into two groups—active and passive scanning. The definition and example of the different types of scanning are given in Table 1.

DEVELOPMENT OF ENVIRONMENTAL SCANNING

Until the 1970s, environmental scanning existed only in a few large businesses. Scanning activity was primarily adhoc, and reactive (Fahey, et. al, 1981; Reinhardt, 1984). Later it was used to provide information for the firm's strategic planning. However, the scanning units at that time were criticized for being isolated from the real world of the corporation. They were unable to incorporate information they collected into the planning process and they were likely to discontinue when the executives who had introduced them moved on (Russell and Prince, 1992).

As scanning became more connected to strategic planning, it became more a "once for all" effort rather a continuous one. It was purely "scanning for planning." There was almost no scanning between planning cycles. During that time, scanning was largely directed to a single person's specific interests. It was not strategy-oriented and did not focus on long-term or company-related trends (Reinhardt, 1984). Most of the data collected were outdated, too narrow, and were not really needed by the senior managers (Fuld, 1992).

Today, information gathered through environmental scanning is critical for the organizational survival and success. Scanning focuses on the identification of emerging issues and potential pitfalls that affect the organization's future. The information helps the organization learn the influences from the environment and how to respond strategically to ensure success.

Table 1: Types of Scanning

Types	Definitions	Examples
Undirected viewing[1] Conditional viewing Informal search Formal search	Expose to information with no specific purpose or information need in mind Expose to information about selected areas Unstructured effort to obtain information to address a specific issue Planned effort to obtain specific information	• Casual conversation • Reading publications for no specific purpose • Browsing specific sections of the newspaper • Observing the market for results of new product pricing • Market analysis
Irregular[2] Periodic Continuous	Ad hoc and driven by some external occurrence or crisis Directed at decisions or issues in the near term; proactive, sophisticated and forecast-oriented Focused on information for opportunity; proactive and long-term oriented	• Ad hoc studies • Budget projections • Sales projections • Periodically-updated studies • Structured data collection systems, e.g. focus groups
Primitive[3] Ad hoc Reactive Proactive	Focused on information without any purpose in mind Focused on information related to specific events Focused on information to respond to markets and competition Focused on information to predict the environment for desired future	• Casual conversation • Reading for no purpose • Browsing specific sections of the newspaper • Market analysis • Reading trade journals • Market analysis • Competitor intelligence gathering
Active[4] Passive	Focused on information in the task and industry environment Exposed to information with no specific purpose or information need in mind	• Networking with friends and colleagues • Reading company and Government Web sites • Reading for no specific purpose
[1]Choo (1998); [2]Fahey, King and Narayanan (1981; [3]Jain (1984); [4]Morrison, Renfro & Boucher (1984)		

THEORETICAL RATIONALE

The relationship between organizations and the environment has its theoretical roots in the organizational theory literature. Two theoretical perspectives provide the theoretical foundations for the proposed model: (1) Information-based view of organizations, and (2) the concept of the adaptation of the firm to its environment.

The Information-view of organizations provides the theoretical basis for the model. According to this view, the external environment is viewed as a source of information (Dill, 1958, 1962) for the organization or to which the organization, via search activity, may get access.

Changes, events, and trends in the environment continually send signals and messages which the organization detects and uses to adapt to new conditions. However, uncertainty is inherent in the environment, and the task of the entrepreneur in coping with this uncertainty is to learn from the environment, and apply the knowledge to change his or her own behavior in a timely manner.

Building on the work of Dill (1958, 1962) and others, Daft and Weick (1984) developed a three step process for acquiring and learning from the firm's environment (i) scanning monitors the environment and provides data to the entrepreneur; (ii) interpretation provides meaning to the data gathered during scanning; and (iii) learning involves a new response or action based on the interpretation. Research studies on the model show that scanning improves organizational learning and performance (Choo, 1998). By adapting this construct of organizational learning, this paper presents a similar model which links entrepreneurs' scanning, organizational learning, and entrepreneurial success.

Another theoretical perspective that is relevant to this model is the concept of organizational adaptation (Milliken, Dutton & Beyer (1990). According to this perspective, organization members scan the external environment of the firm to detect changes or events of significance to the firm. Among all the information that are collected, some pieces are noticed and then given some meaning. Members of the organization eventually developed a shared interpretation of all information and formulate an appropriate response. Ultimately learning takes place when the organization takes action to adapt to the new environmental conditions.

THE CONCEPTUAL MODEL

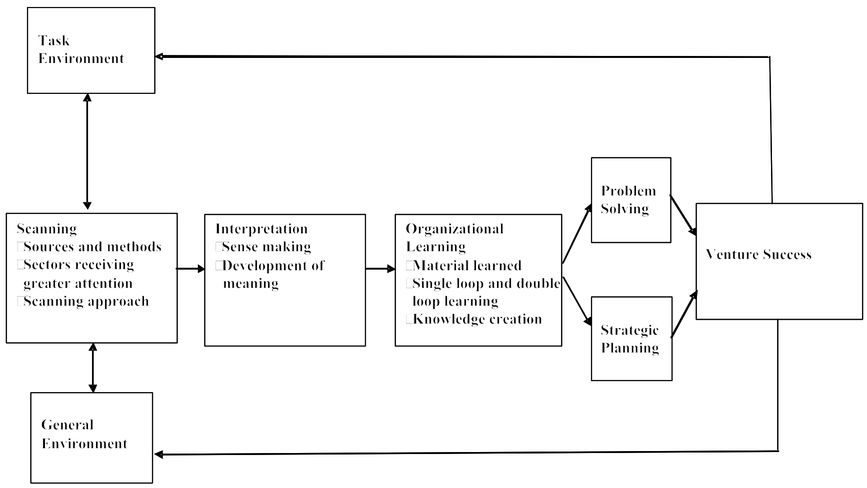
The model, shown in Figure 1, explains how entrepreneurs' environmental scanning can enhance the entrepreneurs' knowledge and lead to improved problem solving, strategic planning, and new venture success. Each element of the model is discussed below.

Environmental Scanning Behavior

Because the use of a formal, dedicated scanning unit is beyond the means of small firms, they rely mainly on informal sources that are personal, external, and informal.

Some of the sources most frequently used are business associates, friends, customers, and other counterparts. They prefer verbal rather written sources of information (Schafer, 1991; Smeltzer, Fan, and Nikoliason, 1988 and Johnson and Kuehn, 1987). Personal sources are considered more credible and trustworthy than published written information (Schafer, 1991.) Other important sources used by small firms are suppliers, TV, radio, newspapers, and peers and colleagues (Jogaratnam and Law, 2006).

Figure 1: Conceptual Model of Entrepreneurs' Information Scanning Behavior and Entrepreneurial Success



Studies in the United States and Canada generally found that the market sector, composed of both the customer and competitor forces (task environment), received greater scanning attention (Johnson and Kuehn, 1987, and Smelter, et. al, 1988). A study by Jogaratnam and law (2006), done in Hong Kong, also found that the task environment (customer and competitor sectors) was given more attention than the general environment.

In small firms the responsibility for scanning is usually in the hands of the entrepreneur (Hambrick, 1981). This individualistic- or top-down approach allows the entrepreneur to quickly scan the environment and take appropriate strategic actions (Nutt, 1989). Also, because of the difficulty in comprehending the rapidly changing environments, entrepreneurs want to be involved in scanning the environments (Choo, 1999).

Generally, environmental scanning behavior in small firms varies depending on the firm size and age. For example, the new and smaller firms tend to be more active searchers of information from their environments, but as the organization grows and time passes, the environment is perceived as less threatening and search will decrease (Mohan-Neil, 1995; Daft and Weick, 1984). Thus,

Proposition (1a): New and smaller firms are more likely to be active searchers of information from the environment.

(1b): Environmental scanning is positively related to organizational learning and entrepreneurial success.

(1c): Entrepreneurs who use personal sources and informal methods for scanning experience greater organizational learning and entrepreneurial success..

Interpretation

According to Daft and Weick (1984) interpretation is the process through which information collected during scanning is given meaning and become new knowledge. Entrepreneurs must literally take the ocean of information that surrounds the organization and make sense of it. An important part of that interpretation and a requirement for organizational learning is to reduce the many and conflicting interpretation of information (Huber and Daft, 1987).

One way entrepreneurs reduce conflicting interpretation of information is by using past experiences to help generate meaning. Using the new information collected from scanning, the entrepreneur retrieves from memory previously encountered situations that are similar to the new information. The information from memory is then used to describe and explain the external events. Organizational memory therefore represents the "lens" through which new information is interpreted (Welsch, Liao, and Stoica, 2001).

During this phase, the entrepreneur disseminates the information throughout the organization to ensure that everyone is involved in its interpretation. It is expected that everyone will be able to make sense of what is happening in the organizational environment and develop a shared interpretation that can serve as a context for organizational action. According to Huber (1991) more learning takes place when more and more varied interpretations have been developed, because such developments change the range of the organization's potential behaviors, and this is consistent with the definition of learning.

According to Choo (1998), the challenge for entrepreneurs is to find the balance between interpreting the information according to existing beliefs (conservatism) and interpreting the data for the exploration of new alternatives (entrepreneurism). Thus,

Proposition 2: *Entrepreneurs who involve other organizational members in the scanning and interpretation process are more likely to experience a greater level of organizational learning and entrepreneurial success.*

Organizational Learning

Organizational learning, according to Cyert and March, (1963) is the process by which organizations learn through interactions with their environment. In this process individual actions lead to organizational interactions with the environment, the environment responds, and environmental responses are interpreted by individuals who learn by updating their beliefs and cause-effect relationships. Individuals are fundamental to the development of organizational learning (Argyris and Schon, 1978, p. 20). There is no organizational learning without individual learning. An organization learns through its individuals (Grant, 1996 and Spender, 1996).

During this stage of the model, learning takes place when the entrepreneurial firm responds to the changes in the external environment by detecting and correcting errors between the business outcomes and its expectations. The entrepreneur modifies his or her strategies, norms, and assumptions in order to bring outcomes and expectations back in line. According to Huber (1991) "an entity learns if through its processing of information, the range of its potential behaviors is changed" (p. 89).

What do entrepreneurs learn from the environment? Entrepreneurs and organizations learn about the forces and events that would have an impact on the organization. Entrepreneurs identify the changes or events in the environment that may affect their companies, and turn that information into knowledge. Because of the rapid changes in today's marketplace, it is easy for an organization to fall behind by not keeping up in areas such as, technology, regulations, and other trends. Learning from the environment reduces the chance of being blindsided and results in greater anticipatory management.

Organizations also learn market information. Market-based organizational learning is unique in that market-based information is more equivocal (Daft & Huber, 1987). For an organization to make sense of its markets and in turn cultivate memory, it must have the proper supply of information (Sinkula, 1994).

Organizational learning also helps entrepreneurs learn about competitors, how they do business, and what they focus on. For example, information on the competitor's manufacturing processes will enable a firm to learn about new and improved processes that will allow it to be competitive. In this way, scanning helps the entrepreneur to maintain its market position and gain competitive advantage (Anand, Glick, and Manz, 2002).

There are two types of learning that take place from environmental scanning – single loop and double loop learning. Single loop learning results in minor adjustments in the business strategy to correct an error without changing existing performance norms. The goal is to increase effectiveness of the business within existing norms (Argyris and Schon, 1996). Double Loop learning results in radical changes of behavior e.g. if the correcting of an error requires changing the business norms for performance, which in turn requires changing the strategies and assumptions associated with these norms (Lant and Mezaries, 1993). Double-loop learning allows the organization to break out of existing thought patterns and to create a new mindset, leading to greater organizational knowledge.

How does learning from the environment enhance organizational knowledge (tacit, explicit, and cultural knowledge)? Tacit knowledge is the know-how, intuition, and hands-on skills that the entrepreneur learns from exchanges with people with whom they come in contact, e.g. customers, suppliers, consultants, and employees from other organizations. Learning from the environment, through personal contacts, depends on intuitive judgment therefore the organization not only uses existing tacit knowledge during scanning, but also develops new tacit knowledge with the learning of additional know-how, intuition, and heuristics.

Similarly, organizations use focus groups, surveys, etc. to find quantitative data from the environment. Because the organization is actively searching for information about the environment, not only is it working with explicit knowledge, but it is also creating explicit knowledge – hard, formal data. Also, when learning from the environment involves scanning reports, databases, publications, etc., cultural knowledge provides the assumptions and beliefs that define the areas of interest. In this case, learning from scanning creates a new frame of reference and new cultural knowledge to be used to describe its reality.

Through environmental scanning, entrepreneurs learn how to respond to changes and trends in the external environment. Organizational learning provides entrepreneurs with a pool of information and knowledge (combination of new and existing knowledge) that they can use to solve routine as well as new problems. Thus,

Proposition 3: *Organizational learning from environmental scanning is positively related to increased individual and organizational knowledge*.

Problem Solving, Strategic Planning and Venture Success

Problem Solving

According to Brush, (1992) and Mohan-McNeill, (1995), the scanning behavior of most small businesses is focused on problem solving in response to immediate survival issues. For example, an entrepreneur may be concerned about a new market he or she is planning to enter, and information from scanning can reduce the risks involved (Anand, Glick, and Manz, 2002). Through scanning, entrepreneurs can develop a better understanding of the context within which the business will operate. Scanning not only helps entrepreneurs recognize customer needs, but also helps them develop a working relationship with them. Similarly, another entrepreneur may have a problem in responding to a new government regulation. Information from scanning will help the entrepreneur better understand the impact of the regulation and what is necessary to adapt to the new situation.

Environmental scanning enhances entrepreneur's knowledge and helps when there is a gap between expected and realized performance. Creating and growing a business is often fraught with many challenges, and often they lack the knowledge and expertise to address the problems. Studies by Daft and Weick (1984), and Holland, Stead, and Leibrock (1976) agree that entrepreneurs will seek information from outside sources when faced with difficult problems. Outside information is critical for problem-solving, planning and the long-term survival of the business.

Strategic Planning

Information from environmental scanning increasingly drives the strategic planning process. Environmental scanning forms the first phase of the strategic planningprocess (Glueck and Jauch, 1984; Mintzberg, 1994; Choo, 1998). It provides the information needed for strategic decisions (Specht, 1987; Dollinger, 1984; Daft and Weick, 1984; Beal, 2000) and for linking environment and strategy (Hambrick, 1982; Daft, Sormunen, and Parks, 1988).

Entrepreneurs gather information from the environment, then analyze and interpret the information to identify potential threats and opportunities. These interpretations form this model for making decisions to guide future actions. Auster and Choo, (1994) stated that entrepreneurs frequently use environmental information in their entrepreneurial decisional roles, i.e., to initiate new improvement projects and strategies.

According to Miles and Snow (1978), successful, proactive firms invest time in strategic planning and in designing a fit between the environment and the business. Planning lays the groundwork for developing the strategic capabilities of the firm. If there is a 'fit" between the firm's strategic capabilities and the environment; the firm's performance increases. Other management scholars also agree that firms that align their competitive strategies with the requirements of their environment out-perform firms that fail to achieve such alignment (Chaganti, Chaganti, and Mahajan, 1989; and Venkatraman and Prescot, 1990).

Preposition 4: A positive relationship exists between the intensity of environmental scanning and the degree of strategic planning and problem solving.

Venture Success

Frequent environmental scanning by small businesses has a positive influence on the firm's performance. However, scanning in itself does not guarantee venture success. Scanning information must be used in strategic planning and integrated with strategy in order to improve business performance.

Research shows that environmental scanning is linked with improved organizational performance. Dollinger (1984) analyzed performance of small firms and found that intensive boundary spanning (measured by number of contacts with outside constituencies) was related to financial performance. Newgren, Rasher, and LaRoe (1984) compared economic performance of companies that practiced environmental scanning with non-practicing firms. Results showed that scanning firms significantly out-performed non-scanning firms.

Daft, Sormunen, and Parks, (1988) compared scanning practices of executives in high performing and low performing medium-size manufacturing firms. They concluded that high-performing firms scanned the environment more frequently and more broadly than low performing firms. They argued that broader scanning may be proactive, provide better knowledge of the environment, and enable the organization to achieve a better strategic fit, and lead to venture success.

Bracker, Keats, and Pearson, (1988) also provided empirical evidence that strategic planning is strongly related to small business financial performance. Similarly, Kotey and Meredith (1997) in a study of small firms in Australia, found that high performers were proactive in their strategic orientation, whereas lower-than-average performers were reactive in their strategic orientation.

Apart from the influence on financial performance, environmental scanning should also be positively related to innovation performance. If a company is good at acquiring new knowledge and articulating existing knowledge with new knowledge, or existing knowledge in a different way, this company should be good at producing innovations Further the better the organizational learning process is, the greater the capacity to develop innovations (product or process) will be (Therin, 2002). Thus,

Proposition 5: *Environmental scanning and organizational learning are positively related to financial and innovation performance.*

SUMMARY

This paper highlights the importance of external information and knowledge in entrepreneurial success. The proposed model contributes to a better understanding of the role of environmental scanning and organizational learning in the entrepreneurial venture success.

The conceptual literature on environmental scanning addressed the general relationship between the use of scanning information and business performance, but it did not focus on the intervening processes of the relationship, such as organizational learning. Therefore, I have argued that environmental scanning is a primary mode of organizational learning. It enhances entrepreneurs' knowledge and leads to improved decision-making, planning, and venture success. It provides a possible explanation for why and how some entrepreneurs are more successful than others.

This model reinforces several elements of current interest to entrepreneurial scholars. The model addresses the scanning behavior in small firms, the importance of outside information and knowledge, organizational learning, strategic planning, and entrepreneurial success. As such, this model highlights empirical measures that might be tested with entrepreneurs.

IMPLICATIONS FOR ENTREPRENEURS

The model has two implications for entrepreneurs:

(1) It implies that entrepreneurs should be continuously learning from the environment. Entrepreneurs, no matter how experienced, need to learn from and use information from the external environment. They need to closely monitor the events, trends and changes in the environment to foresee and exploit opportunities not seen by the competitors. They need to have insights into factors affecting customer demand, such as, the economic, political, and technological trends in the environment. Entrepreneurs who are able to make the necessary changes to adapt the firm to the environment are more likely to have long term success.

(2) It also has implication for creating a greater individual and organizational knowledge base. Through scanning and organizational learning knowledge is acquired from outside the firm. This knowledge is then combined with existing knowledge which results in the creation of new knowledge. For example an entrepreneur identifies outstanding practices from well positioned competitors, evaluates a particular process to identify gaps or problems in the design, then captures the knowledge for firm's use. The firm will then absorb the new knowledge increasing the individual and organizational knowledge base.

IMPLICATIONS FOR ENTREPRENEURSHIP EDUCATORS

The implications for educators are:

(1) Training in environmental scanning, or at least discussion of the topic, should be included in all entrepreneurship programs. The benefits of such training might be especially helpful for newer firms. These entrepreneurs often have very little history to rely on, and tend to actively search for information (Sinkula, 1994). Competence in scanning will help them better understand the importance of scanning as well as get its full benefits.

(2) Opportunities should be provided for student entrepreneurs to interact with other successful entrepreneurs so they may begin to engage in scanning activities and start to value the importance of learning from the environment.

Apart from the implications discussed above, perhaps the most important contribution of the model is that it extends the discussion on environmental scanning behavior and entrepreneurial success. The intention is to encourage further research to fill what is perceived as a gap in the literature.

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THE USE OF NON-MONETARY MOTIVATORS IN SMALL BUSINESS

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ABSTRACT

The present paper provides small business owners and entrepreneurs with a variety of techniques that can be used to motivate employees without increasing salaries. Small business owners and entrepreneurs have an advantage over larger businesses by being able to know their employees, treating them as individuals, and tying rewards to the things that these employees value. The things that employees might value, such as being treated with respect and having a flexible work schedule, might be an advantage that small businesses can offer, which might increase the ability of small business owners to attract and retain quality employees. Additionally, employees can be developed in ways that will benefit both the employee and the small business, and represents a level of involvement that these employees might not find in larger organizations. These actions by small businesses can result in situations where the performance of small businesses can be improved without tying up limited financial resources.

INTRODUCTION

Any business that has employees faces challenges keeping them motivated. Both large and small businesses attempt to use financial incentives to motivate employees to achieve the organization's objectives (DeCenzo & Robbins, 2007). One challenge that small businesses face is that they do not have the same ability to pay as large organizations (Milkovich & Newman, 2008). This creates a challenge for small businesses when it comes to attracting and retaining quality employees (Howard, 1998; Howard, 1999). Given this combination of challenges, small business owners need to consider a variety of options when attempting to motivate their workforces.

The present paper focuses on non-monetary motivators that small businesses can use to assist them in keeping their employees motivated. The first section of this paper focuses on how small business owners might treat employees. In this section, the importance of getting to know your employees, communication with employees, and fairness and respect towards employees will be addressed. The second section of the paper focuses on developing employees in a small business. The role of performance appraisal will be presented, along with involving your employees in the planning and running of the business. The next section of the paper will focus on rewarding employees in small business. Specifically, the use of non-monetary rewards such as recognition and other rewards that employees' value should not be overlooked. The fourth section of the paper will focus on work schedules. The main focus of this section will be on the benefits of flexible work schedules, and how small business can gain and retain valuable employees while using flexible work schedules. Finally, conclusions of the paper will be presented.

TREATMENT OF EMPLOYEES

It is important for any organization to treat its employees with respect, since it is employees that make the difference between success and failure for most organizations (Howard, 1998). While this might appear to be a simple issue, it is especially important that small business owners capitalize on treating their employees well in order to get the greatest benefit from the employees, as well as increase retention. Treating employees with respect, as well as greeting each employee everyday by saying "Good morning", can go a long way to establishing a reputation as a business owner who cares and takes an interest in his or her employees at a personal level, which may be different from what employees have experienced in larger organizations. This can lead to a tremendous value for small businesses. In order to develop this value, a small business owner needs to first get to know his or her employees. Three ways to treat employees well are to get to know your employees, communicate with your employees, and ensure that employees are treated fairly and with respect.

Get to know your employees.

An opportunity that small businesses have, which large organizations might not have, is that the small business owner can get to know each and every employee. Small business owners can gain a lot of respect by knowing each employee by name, as well as taking a personal interest in each employee. By listening to employees, small business owners not only gain the confidence of their employees, but they also learn what motivates these employees (Howard, 1998). Learning about the skills and abilities that the employees have can help the small business employ these individuals in areas that capitalize on their strengths. Small business owners need to remember that all employees are different from one another. As such, two employees might not value the same things. By getting to know what motivates your employees as individuals, as well as knowing what each employee can do for the small business, small business owners are in a better position to deliver a reward that the employees' value, as well as understanding how employees will respond to changes in the workplace and how these changes should be communicated (Harris & Arendt, 1998).

One way that small business owners can get to know their employees better is to have a meal with some of the employees on a monthly basis (Ortega, 2006). While a small business owner may not be able to do this with every employee every month, it does provide an opportunity for a small business owner to really get to know what his or her employees like and do not like about their work, as well as identify areas that can be improved for the business. This helps the small business succeed, as well as lets the small business owner better understand what his or her employees value. Furthermore, this can help a small business retain quality employees.

While communicating with every employee on a personal level everyday might not be feasible for all small business owners, at a minimum small business owners should meet with their employees on an annual basis to provide them feedback about their performance (DeCenzo & Robbins, 2007). During this meeting, small business owners can further identify which parts of the employees' jobs are important to them, as well as their career aspirations. Employees can learn which aspects of their performance are above the performance standards, which aspects meet the performance standards, and which areas need improvement (Pomeroy, 2004). Getting to know employees strengthens the relationship between the employee and the small business, as well as allows the small business owner the advantage of knowing how to handle each employee, whether the small business owner is handling rewards or informing employees of changes.

Communicate with employees, not at them.

When getting to know your employees, small business owners should consider taking that same type of communication pattern to the next level, communicating with employees on a regular basis, rather than communicating at employees (Howard, 1998). This includes listening to employees and their ideas. Employees help the small business succeed, and they might see ways in which work can be done more efficiently, since they are focused on a smaller part of the picture than the small business owner. By listening to employees, the small business might be improved, benefiting all in the small business. While it is not always feasible to speak with each employee directly on a regular basis, bulletin boards can be put up so notices and announcements can be posted. This type of activity opens up communication throughout the organization.

Change in any organization is inevitable, and the same is true for small business. Ensuring that employees understand where the small business is going and how this will influence them in their job is critical to organizational success (Howard, 2006). The primary way to ensure that employees understand where the small business is going and the implications of the changes is through communication (Dyer, 1996; Nicholls-Nixon, 2005). While bulletin boards might be an appropriate communication channel for some types of notices and announcements, face-to-face communication when organizations are going through transitions and change help employees understand the changes, resulting in less resistance to the changes (Larkin & Larkin, 2005). As the quality of communication increases in the small business, employees become empowered, committed, and organizational goals are more likely achieved (Brunetto & Farr-Wharton, 2004).

One of the ways that improved communication can be achieved is to facilitate lively, informative staff meetings, where the employees are actively engaged. This involves the employees more than meetings where employees are directed what to do. The more you draw out of your employees, the better the small business will become, as these employees will become more committed to the business (Rosen, 2004). Additionally, hold regular forums for all employees where the employees are encouraged to open dialogue on work issues. At Johnsonville Sausage LLC, production employees hold meetings prior to each shift, discussing the state of operations, as well as addressing any problems that have arisen (Pomeroy, 2004). All employees are directly involved, and as a result, Johnsonville Sausage was on the 2004 list of Best Small and Medium Companies to Work for in America (Pomeroy, 2004). Employees ideas are addressed and employees believe that they are actively engaged in the running of the organization, resulting in turnover that is lower than the industry average.

A major benefit of communication for small business owners is that employees and small business owners alike develop trust in one another (Howard, 2006; Tzafrir & Dolan, 2004). As trust develops, conflict within organizations has been found to be reduced, as well as increased productivity and performance among employees (Ferres, Connel, & Travaglione, 2004; Perren, 1998; Sharif, Kalafatis, & Samouel, 2005). Trust has not only led to these positive organizational effects for small businesses, but trust has also been associated with an increase in profits, while avoiding the negative situations where a lack of trust has led to the inability of small business owners failing to delegate tasks, leading to burnout (Gomez & Rosen, 2001; Howard, 2001; Howard, 2006; Rosen, 2004).

Treat employees fairly and with respect.

One of the fastest ways to help gain the commitment of employees toward a small business is to treat employees fairly and with respect (Howard, 1998). Employees will be more likely to work harder, and will be less likely to leave the organization if they are respected and appreciated (Pomeroy, 2004). One way that small business owners can go about maintaining respect for their employees is to regularly look at what their employees are doing. This can be accomplished by shadowing their employees occasionally, seeing directly the challenges employees face and how they successfully address those challenges (Pomeroy, 2004). This will help small business owners identify the resources that the employees need, as well as remain familiar with the myriad of challenges that employees face. While one might think that a small business owner would be familiar with all of the aspects and challenges associated with his or her business, it is easy to become removed from the issues that face line employees, as the small business owner is the primary marketing strategist, financial officer, human resource manager, in addition to the operations manager and owner. Given all of these responsibilities and duties, it could be easy to forget all of the details faced by line employees. Shadowing workers occasionally helps the small business owner remember all of the challenges that he or she once faced himself or herself.

Respect and fairness are so important to employees that they represent two of the five themes that the Great Place to Work Institute Canada examined when selecting the 30 best places to work in 2006 (Wahl, 2006). The model used to evaluate organizations in Canada has been used by Fortune magazine when determining its Top 100 lists, and largely focuses on how employees are treated and cared for in organizations. Ultimately, if an organization is a great place to work, employees will be committed and productive, and the organization will succeed. Success is something that every small business hopes to achieve, and treating employees fairly and with respect can help achieve this success.

It is important to remember that getting to know your employees requires communication, and the more you communicate with your employees will help you to better know them. This further helps small business owners develop a workplace that employees view as one that is respectful and fair. If a small business owner can effectively develop a workplace atmosphere that includes these aspects, the business is more likely to succeed.

DEVELOP YOUR EMPLOYEES

Developing employees in a small business is a second area of importance to the success of the small business. While open communication helps encourage employees to develop their ideas, there are additional ways that small business owners should consider developing their employees. Developing employees can help them further understand how they can help the organization, and this can help the small business owner understand how they can help the employees improve their performance and achieve their personal goals (Harris & Arendt, 1998). Two ways that small business owners can develop employees is by conducting performance appraisals on every employee, as well as involving employees directly in the business.

The use of performance appraisals.

One way to develop employees is by conducting performance appraisals for all of the employees in a small business. While many managers in all types of business do not like to use formal performance evaluation techniques, viewing the use of time to do so as time better spent working on other issues, performance appraisals are an excellent tool that can be used to develop employees (Latham & Wexley, 1994). Certainly, employees need to know if they are not performing their tasks correctly or to standard. If they are not informed of mistakes, how would they be able to take corrective action? As such, even if formalized performance appraisals are not conducted in organizations, informal feedback can address areas of poor performance as needed. The Calvert Group takes this approach, focusing performance appraisal from an informal perspective (Barrier, 1998).

While the informal performance appraisal approach might be preferable and appropriate for some small businesses, there are advantages to implementing a formalized process that might outweigh the time commitment to administering such a system. First, by implementing a formalized system, employees are ensured that they will receive feedback on their performance on a regular basis. This is important because most employees want to know how they are doing, but with the day-to-day activities at work, there can be times where employees do not receive an assessment of their performance in an informal setting. During the performance appraisal interview or review session, an employee can meet with the small business owner and discuss the areas of successful performance, as well as areas that need to be improved. This keeps employees informed of their performance, as well as giving them the opportunity to solve performance problems. It is important during this session that communication is two-way, meaning that employees are given a chance to speak to the issues of their performance. At Northeast Delta Dental, the session is viewed as one where not only are employees provided with feedback, but employee's ideas on how to improve performance are not only listened to, but encouraged (Pomeroy, 2004). Employee's ideas are often times implemented because they were viewed as effective ways to improve not only their performance, but how the business could be run. Ultimately, this develops employees to a point where they begin to proactively understand how they are performing, and can take action to improve performance on their own.

Unfortunately, there are situations when conducting performance appraisals when there might be more negative information to discuss about an employee's performance than positive information. It is important to note that when a small business owner provides feedback about performance that the feedback is focused on the performance, not the employee himself or herself (Howard, 1998). It is important to hear the employee's perspective, but to remain focused on the performance standards, and keep the situation from degenerating into a situation where the employee feels that he or she is being picked on. Opening up communication, and providing ways to improve can assist in helping the employee see how they can take the feedback and use it to their advantage.

Involve employees in the business.

Unless a small business is a one-person operation where the small business owner has no employees, it is important to understand that employees will have a tremendous effect on the success of the business. Given this, it is important to develop employees so that they can take over operations and activities as necessary, as small business owners should desire to have a situation where they own the business and not a situation where the business owns them. Involving employees in the business helps employees to understand the business as a whole, and not just the job that they are performing. At Johnsonville Sausage LLC, employees are indoctrinated into a culture of involvement from the time they begin working for the company (Pomeroy, 2004). All employees go through initial training where they are trained not only on their jobs, but about how the organization runs, teamwork, and how the finances of the organization are managed, to include their influence on employees. The goal is to create a situation where all employees understand that they influence the organization as a whole, and that Johnsonville wants employees to be involved, offering the organization ways to improve. Because of this approach, when teams do not meet monthly production goals, they voluntarily meet to determine as a team how to improve their performance so that goals are met (Pomeroy, 2004). These meetings are not required, but employees have developed a commitment to high performance because they have been involved in all aspects of the business from the beginning of their employment. Their involvement has helped them develop as employees, gaining an understanding the effects of their operations on the organization as a whole.

Another way to develop employees is to take them to meet with customers. This allows the employees to understand how what they are doing is influencing customers, and what the customers may further want in the product. In addition to meeting with customers, employees learn from each other when they meet as a group working on a common problem or project. When working on research projects associated with counterterrorism and criminal justice, employees at Mitretek Systems find that they learn a lot from each other when they meet to share information and ideas (Pomeroy, 2004). By sharing ideas at meetings, employees learn from the perspectives and experiences of each other. There are team leaders present for these meetings, but employees are involved to a point where team leaders are viewed as partners, and not bosses, allowing for the further development of the employees.

At the biotechnology firm of Genecor International, the organization develops employees by placing them in jobs that are different than what they have been educated or trained for (Pomeroy, 2004). The organization does this for a variety of reasons. One reason is that it further develops the employee, making them more valuable to the organization by being able to contribute in a wider variety of ways. The second reason is that it helps the work group to see things from a different perspective, developing the other employees in the work group.

By involving employees in small business through these various techniques, the employees develop an understanding of what the business is about and where the business is going. This can particularly assist a small business owner in developing a shared business logic among the employees, so that employees can step in when the business owner might not be present (Nicholls-Nixon, 2005). This is a common situation for small businesses when formalized plans and procedures have not been formalized. By developing employees through a variety of techniques, such as those outlined, small business owners are creating valuable employees, as well as keeping employees actively engaged in the business.

REWARDING EMPLOYEES

Rewarding employees is critical for any business organization. In today's business world, employees demand adequate rewards, and if they are not rewarded to the level which they believe they deserve, they might leave the organization for better alternatives. This is a challenge for all organizations, but can be a greater challenge for small businesses. Small businesses may not have the ability to pay employees that large businesses have (Milkovich & Newman, 2008). There are a variety of reasons for this, such as a lack of revenue, the lack of market share, or the reinvesting of profits into the business. Additionally, it has been noted that small businesses have faced challenges associated with being able to pay salaries to employees at an appropriate or competitive level (Howard, 2006). All of these factors are issues that small business owners need to consider addressing. However, there are rewards that small business owners can offer that employees will value. Small business owners should not overlook the influence that non-monetary rewards can have on employees. The benefits of each of these types of rewards will be discussed in the next several paragraphs of this paper.

The use of non-monetary rewards.

While most organizations focus on the use of monetary rewards, non-monetary rewards may not only be less expensive, thus more viable, for small business owners, they might be just as effective as monetary rewards. When one considers that most employees of any business spend as much or more of their waking hours at work than with the people they choose to live with, work is a big part of any employee's life. Given this, the work environment may be a critical part of the decision to remain with an employer, in addition to the monetary rewards. Going to work at a place where everyone gets along and people feel that they are appreciated is important to many employees, especially when workers are putting in long hours. Some nontraditional rewards that Analytical Graphics, Inc. offers its employees are breakfasts, lunches, dinners and snacks, that the employees and their families can have (Rubis, 2004). Other companies offer free cab rides home after certain times, to ensure that employees are taken care of (Oldfield & O'Donovan, 2001). These companies offer these rewards or perks because employees put in so many hours to ensure that the company is successful. While they do not cost a lot, relative to permanent increases in wages, they do mean a lot to the employees.

An often times overlooked reward that small business owners can give to employees is recognition. Recognition can take many forms, from recognizing the years of service that employees have given the company to recognizing performance for a job well-done. Some employees may want to ensure that their efforts are being acknowledged, and letting these employees know that they are doing a good job and are appreciated can go a long way to keeping them satisfied and motivated (Anonymous, 1999). Additionally, by recognizing employees, the organization can benefit by either reducing turnover levels or keeping them low, especially if a reward is tied to the recommendation, such as a gift certificate to a local restaurant or spa or additional paid time off (Caggiano, 1997; Mintzer, 2006).

Employees are not only critical to organizations that manufacture goods, employees are also critical for ensuring that customers are taken care of, and that their needs are met. Using rewards to recognize the extra work that employees do has been found to keep morale of the workforce high (Wallsten, 1998). Giving employees certificates and choices in gifts lets employees know that others are seeing the important work that they are doing, as well as giving employees a chance to get something that they might not go out and get for themselves. These rewards can range from movie tickets to books. Small business owners have an advantage over managers in large organizations when rewarding employees this way; their knowledge of the employee, and what they employee is interested in. If a small business owner knows that an employee has a specific interest, the reward can be something related to that interest. For example, an employee might be interested in fishing. If this is the case, a gift certificate to a company that produces fishing equipment, a sporting goods store that carries fishing equipment, or tickets to a fishing and tackle expo at a local civic center might be a reward that is not only something that the employee will use, but that the employee values.

The examples given represent a small number of the endless possible ways that small business owners can reward employees with non-monetary rewards. Small business owners must not overlook the effectiveness of non-monetary rewards, as they are valued by employees and may be inexpensive, which may be attractive from a small business owner's perspective. If small business owners consider using bonuses and non-monetary rewards, they need to reward and acknowledge employees immediately following performance if they want the employee to make the connection between their performance and the reward (Gale, 2002).

WORK SCHEDULES

For many years now, the U.S. work force has felt the pressures associated with working many hours, the effects of these work schedules on the ability to take care of personal needs (Howard, 1998). Most of the needs that employees have require attention during the same hours of work, creating situations where employees might have to make difficult decisions about whether to go to work or to take care of their own health, for example. A benefit that does not cost a small business owner from a financial standpoint is to offer flexible work schedules. That does not mean that this benefit is without challenges, but it is a benefit that might enable small business owners to attract and retain quality employees in some instances.

Flexible schedules represent a benefit that can be simple to offer, if managed appropriately. If a worker has an issue to address during normal business hours, such as a doctor's appointment or meeting with a teacher of a child, the employee could be allowed to take the time off as necessary, working later during a given day or making the time up sometime during the pay period. By doing this, the employee can take care of their issues, not lose income, and the employer gets the productivity that he or she needs, without incurring the costs associated with having to pay overtime to an employee. This is a benefit that can be used as needed, when employees have issues that they need to address.

An alternative to handling flexible schedules for employees using informal systems is to implement a formal work schedule system that can accommodate employees who have needs to address outside of work. One option is a compressed work week, where employees work four days per week, working 10 hours per day, rather than the traditional eight hour day where an employee works five days per week. This allows employees to have an extra day off during the week where they can address personal issues during the typical hours that doctors are open and teachers might be available for meeting with parents. An added benefit is that in metropolitan areas, by working longer days, workers can commute to and from work during off-peak commute hours, resulting in shorter commute times. This is a result that Kaufer Miller Communications found when they offered the benefit to their employees in the Seattle area (Caggiano, 1997).

A second formal option for small business owners is to establish a formal flex-time schedule, where employees consistently work hours that vary in terms of when they begin or end the work day. For example, employees might have to be at work for a given two to four hour period, such as 10 a.m. to 2 p.m., but they can come in early or leave late, just as long as they put in the hours at work which they are required to work. This could allow a worker to begin work at 6 a.m., resulting in a situation where they can leave work at 2 p.m. This provides a number of benefits to employees. First, it allows employees to commute at times when there might be less traffic. Second, it allows employees the flexibility to attend to personal needs, such as taking college classes, without too much disruption to the business. Finally, some employers such as Campus Creations in Urbana, Illinois, prefer this option, because it generates a consistent schedule for the employer that he or she can count on, while helping to retain quality employees by working with them (Klimos, 1995).

A third option is to create job opportunities that are either permanent part-time employment opportunities. Traditionally, these would be employment opportunities that would allow an employee to work a set number of hours or days per week. Quill Corporation in Lincolnshire, Illinois has had success with employing professionals who want a work-family balance in a permanent part-time basis (Rowland, 1993). As part of the decision on how people want to spend their time, there is a segment of the workforce that wants to maintain some level of connection to their profession while raising a family, but still have the opportunity to spend quality time with their family. If a small business can develop a program that allows the business to succeed with part-time employees, it is possible to attract and retain quality employees on a part-time basis. A variation of this option has been used successfully by small businesses in England, where RAMSAC, an Information Technology consulting firm, has employees who are on nine month contracts, having the summer months off with their families (Merrick, 2002). The key to these options is dependent upon the creativity of the small business owner, in terms of what they want to offer, as well as how they want to manage and monitor the work in order to ensure that it is a successful arrangement.

A fourth option that can be considered by small business owners is the option of allowing employees to work at home (Caggiano, 1997; Mintzer, 2006). This option, like the others presented, will not work for all positions in any organization, but if it is a viable option, it could be beneficial to the employee, resulting in benefits to the small business in terms of productivity and retention. This allows employees to tend to the type of personal needs previously mentioned, as well as allowing employees to remain productive for the small business in situations where children are ill. When children are ill, neither school nor daycare will allow the children to attend. As a result, a parent typically must remain at home with the children while they are ill. In a traditional work situation, this would result in an employee missing a day of work, as well as the business potentially falling behind schedule. If the job has the flexibility to be performed from an employee's home, both of the situations presented can effectively be avoided.

Flexible work schedules, while not feasible for all small businesses or all jobs in any one business in particular, can be beneficial to a small business owner if they are in a position to offer them. The options available to a small business owner are seemingly endless, limited only by the creativity of the small business owner. A small business owner needs to think through what they want to achieve, and determine if the options presented will effectively meet their needs.

CONCLUSION

Small business owners have numerous challenges when operating a small business. In many cases, small business owners might not be able to offer the same types of benefits as large businesses, as well as the same level of wages. While this might represent one disadvantage that small businesses face, it also provides opportunities for small business owners. By utilizing non-monetary motivators, small business owners can offer employees things that large companies are not in a position to offer. Specifically, small business owners are in a position to know each and every one of their employees. By getting to know his or her employees, a small business owner can ensure that when they recognize and reward their employees for outstanding performance that they are rewarded with something that the employee values. These non-monetary rewards might be more effective than other options, as the employee might develop a loyalty and commitment to the organization. Also, working with employees to meet their developmental needs, as well as working with them on their schedules, can establish a situation where the small business owner wins while the employee wins, and this might represent a set of options that employees might not be able to find in large companies. Ultimately, these options help small businesses succeed, and are up to the small business owner to determine whether or not they are feasible in the situation that they face.

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THE EVOLUTION OF A KEY INTERNAL REVENUE CODE SECTION: THE HOME OFFICE DEDUCTION

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ABSTRACT

Under the Internal Revenue Code, taxpayers have been able to deduct their expenses in conducting a business or earning their income. Such expenses would include those of maintaining an office for the conduct of the business, even if that office was in their home. The advances of the internet have made working at home commonplace, and added to the importance of a home office. After a period of relative ease about claiming the "home office" deductions, taxpayers began to lose that privilege, because of some restrictive tests imposed by the Internal Revenue Service (IRS); several taxpayers fought back and the courts sided with them, rebuking the IRS and crafting some new judicial doctrines explaining their decisions. But in a controversial 1993 case, the Supreme Court reversed course and imposed some difficult requirements for the deductions. That decision was not without controversy, as two of the Supreme Court Justices in the majority noted that "the issue is no clearer today than it was before" while the sole dissenting Justice stated that "the court's decision misreads the law and unfairly denies an intended benefit to the taxpayer".

This research examined several cases, in light of recent legislation, particularly the Tax Reform Act of 1997, and the tightened requirements for the deduction. It suggests that many professionals render their services from a home office and thus need that deduction. The research also examined some of the unintended consequences of taking the deductions on the subsequent disposal of the home. It asks in conclusion: Tax trap or discrimination against some professionals?

INTRODUCTION

Under the Internal Revenue Code (IRC), taxpayers have traditionally been able to deduct all of the "ordinary and necessary" expenses of conducting a trade or business from the revenue generated by such business (Internal Revenue Code § 162). For those not engaged in a regular "trade or business but who nevertheless derive some income from a certain activity, their expenses related to the production of that income are also deductible (Internal Revenue Code § 212). Thus, many taxpayers have in the past been deducting the cost of maintaining an office at home where they conduct either a regular business or some income producing activities. Examples would cover lawyers, doctors, salesmen using an office at home to prepare legal briefs, consult with patients or perform other administrative tasks related to their income generating work. Given the technological advances making telecommuting more prevalent, and more advantageous for both employees (flexibility, reduced commuting costs,) and employers (cost savings of not having to provide office space), the use of home office has vastly increased in our economy, going from an estimated 1.5 million taxpayers in 1991 to a far larger segment of the work force (Hoffman et al. *Individual Income Taxes, 2006 ed. West Federal Taxation, Thompson, South-Western*).

Until the middle part of the seventies, it was fairly easy for taxpayers to receive these deductions. So long as they could substantiate, by their records and receipts, their expenses in generating the income or in conducting the trade or business, they were virtually assured of the deductions for such items as a portion of the mortgage or rent payments, of the utilities, of the cost of furnishing and generally maintaining that portion of their home used as the "home-office". In the event of an audit by the Internal Revenue Service, they usually prevailed as long as they could show that the expenses involved were "appropriate and helpful" and "reasonable" in the trade or business.

The restrictions of Code Section 280A

In search of additional revenues to reduce the large federal deficits, in 1976 Congress enacted IRC section 280A, thereby imposing much stricter rules for those deductions. The new requirements were:

1. Taxpayer had to use the home office "exclusively" and "regularly" for business purposes.
2. That home office had to be taxpayer's principal place of business.
3. It had to be a place of business used to consult with clients or patients.

The Internal Revenue Service (IRS) enforced the first requirement to the letter, meaning that the home office had to be a location separated by some wall, partition, curtain or other physical demarcation. The United States Tax Court disagreed, saying that it found no such requirement in the legislation. That Court even ruled that a large walk-in closet would qualify as a home office (Tax Court Memo 1981-140). The second part of the first requirement still had to be met, that is the space had to be used regularly, not intermittently, for the business or income producing activity.

The second requirement generated even more controversy. What was to be considered the taxpayer's principal place of business? To help in the interpretation, the courts employed a new concept, "the focal point test". In the case of an employee, the principal place of business, that is, the focal point of his activities was deemed to be the business premises of his employer. This became almost an insurmountable obstacle for most employees. In one case, an expert violinist was hired by the opera at a large metropolitan area. During the performing season, he spent about 26 hours per week rehearsing at the opera center. But since the employer did not provide him with any private office facilities, he set up a studio at home to perfect his skills. Despite his unchallenged testimony at the trial, that usually he would spend 30 hours per week rehearsing in the home studio, the Tax Court denied him the deduction, using the reasoning of "the focal point test". The Court stated that the focal point of his activities was the opera center, not his home, in spite of the fact that he spent slightly more time there than at the center. Similar results were reached in case after case, when employees, faculty members, lawyers or consultants tried to deduct their home office expenses (Chauls, R. TC Memo 1980-471; Bilenas, TC Memo 1983-661).

Reversals and controversy

Those taxpayers, feeling unfairly treated by the application of this "focal point test", appealed their cases. The Second Circuit Court of Appeals dealt the IRS a significant setback in reversing a previous Tax Court decision. The undisputed facts were that a professor, Mr. Weissman, of a large university was spending most of his working time, not lecturing, advising students or grading papers on campus but rather doing research and writing in two of the ten rooms of his large residence. While the university provided him with an office, he had to share it with other colleagues and it was "not a safe place to leave teaching, writing, or researching materials and equipment." (Weissman v. Comm. (2 Cir; 1983) 55 AFTR2d 85-539, 751 F2d 512, rev'd #85, 724 PH Memo TC). He satisfied the other conditions, since he showed to the satisfaction of the court that those two rooms were used "regularly" and "exclusively" for his research and writing activities. It also helped that he was writing a book at that time. The Appeals Court found that the Tax Court had misapplied the "focal point test" in the case, saying that the professor was engaged in two complementary but separate types of activities, both of which were necessary for receiving tenure, promotion or advancement from the university. The first portion of his activities, his teaching, was conducted on the premises of his employer; the second one, a "dominant" portion, his research and writing, were conducted in his home office. "To the extent that Tax Court found [the] College to be the focal point of Professor Weissman's employment activities simply because he taught courses there, it erred as a matter of law by failing to consider all aspects of his activities (Ibid).

A different Appeals Court, the seventh, also ruled against the IRS in a later case. Sally Miers, an employee of a corporation, set up a home office where she did some work in connection with her employment. When the IRS objected to her deductions for the expenses of maintaining her home office, she went to the Tax Court. The latter, invoking the "focal point test", sided with the IRS. In reversing, the Seventh Circuit Court of Appeals stated: "We, like the Second Circuit, question the usefulness of the focal point test…As applied by the Tax Court, [it] places undue emphasis upon the location where goods or services are provided to customers and income is generated, not necessarily where work is predominantly performed. The focal point test is concededly easy to apply…Yet we do not believe this approach is fair to taxpayers or carries out in the most appropriate way the apparent intent of Congress…In applying these standards to the present case, we conclude that the Tax Court erred in denying taxpayers a deduction for a home office…We reverse the decision of the

Tax Court…" (Meirs v. Comm. (7 Cir; 1986), 57 AFTR2d 86-642, 782 F2d 75, rev'd 84, 607 PH Memo TC)

More restrictive requirements and a possible trap.

The IRS appeared defeated as many similar court rulings went against it. But in 1993, the United States Supreme Court reversed in favor of the IRS an Appeals Court decision which had affirmed a previous Tax Court ruling favoring a taxpayer. An anesthesiologist at three hospitals in the nation capital, Dr. Soliman, had set up an office at his residence to perform work related activities: update his patients' records, read medical journals, consult with patients by telephone. He had to do so, he testified at the trial, because none of the three hospitals provided him with a private office on their premises. In reversing the Appeals Court decision, the Supreme Court introduced a new element, that of "the comparative importance" of the activities. "The essence of the professional service provided by the doctor was treating patients (in the hospital operating rooms), not maintaining patients' records (done in his home) (Soliman v. Comm. (1993), 71 AFTR2d 93-463, -US-Sct., rev'd (4 Cir; 1991), 67 AFTR2d 91-1112, 955 F2d 52, 94 TC 20. No. 3). Thus, the home office became less important than the hospital rooms and the deduction is denied.

As the controversy continued among new victories for the IRS, Congress enacted new amendments on the subject to the Internal Revenue Code. In addition to the requirements of Section 280A, the Tax Reform Act of 1997 stated that the term "principal place of business" now must also satisfy the following ones:

1. The office is used by the taxpayer to conduct administrative or management activities of a trade or business.
2. There is no other fixed location of the trade or business where the taxpayer conducts these activities (Hoffman et al. *Individual Income Taxes, 2006 ed. West Federal Taxation, Thompson, South-Western*).

In effect, those new requirements have now made it all but impossible for an employee to deduct expenses for a home office when he is provided with office space by his employer.

The tax trap

A tax trap can be defined as any unwanted or unforeseen tax consequences forcing the taxpayer to either pay more taxes or to forego deductions to which he believed he was entitled. Some of these traps may be judicial, some statutory and some simply the result of judge-made precedents. Examples would be the step transactions doctrine, the collapsible corporation rules, and the constructive ownership regulations. (Sommerfeld, Ray, *Federal Taxes and Management Decisions, 1986, Richard D. Irwin, Inc. Homewood, Ill*). The deduction for a home office, even by a self-employed person who is entitled to it, may become such a trap at a subsequent sale of the primary residence in which the home office was located. A taxpayer may exclude up to $250,000 ($500,000 if married and filing a joint return) of the gain from the sale of his principal residence if he had lived there at least two of the five years preceding the sale (IRC section 121). But what effect would a previous deduction for a home office in a residence would have on the availability of Section 121? While some uncertainties lingered for some time, the IRS finally clarified its position. It ruled that only the depreciation deduction claimed on the home office portion of the principal residence after May 5, 1997 would have to be reported as taxable gain, while the balance of the gain would remain eligible for the exclusion of code section 121.

In summary, the home office deduction has effectively been taken away from most employees, especially those who are furnished an office on the business premises of their employers. Even if such office is not provided, the five conditions of both section 280A and of the Tax Reform Act of 1977 would have to be met for the deduction to be claimed. Such a deduction remains available for the self-employed, but under strict adherence to the IRC provisions. Finally, even a legitimate deduction can trigger a somewhat unfavorable tax treatment at a later sale of the primary residence where the "home office" is located.

BULLETPROOFING SPECIAL ALLOCATIONS

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ABSTRACT

Partnerships are attractive investment vehicles because they are not taxable entities and because partners generally have the ability to allocate any item of income, gain, loss, expense or deduction among themselves as they wish.

The ability to allocate losses may lead to taxpayer abuses. To curb potential abuses, Congress and the Internal Revenue Service (IRS) have placed limits on special allocations, requiring that the allocation has "substantial economic effect."

The Regulations provide that the determination of substantial economic effect consists of a two part analysis that is made at the end of the partnership taxable year to which the allocation relates. The allocation must have economic effect and the economic effect must be substantial.

To have "economic effect" a partner's capital balance must be adjusted for allocations and distributions and the liquidation of a partner's interest must be based on the readjusted capital account balance with any deficit balance restored by the partner.

To be "substantial", there must be a reasonable possibility that the allocation will materially affect the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

This paper discusses the requirements for successfully shifting tax benefits between partners through special allocations.

INTRODUCTION

Partnerships and those entities taxed as partnerships have always been popular forms in which to conduct business because the partnership itself is not subject to federal income taxation and the partnership under Internal Revenue Code (IRC) section 704(b) may specially allocate to the partners items of income, gain, loss, deduction, or credit.

The opportunity to specially allocate these items to minimize overall partner tax liabilities is very attractive and could be abused. To prevent abuse, both the code and subsequent Internal Revenue Code Regulations (Regs) limit the use of special allocations. Additionally, over the years a body of case law has developed that sets out limits but also offers some planning opportunities. Successfully providing for special allocations requires avoiding the numerous pitfalls surrounding this provision. Properly using the guidance in the Code, Regs, and case law will bulletproof partnership special allocations from successful attack by the Internal Revenue Service (IRS).

SPECIAL ALLOCATIONS

Interestingly, the term "special allocation" does not appear in the IRC itself but does appear in the Regs and the legislative history to the Tax Reform Act of 1976 (S. Rep No. 938, 94th Cong., 2nd Sess 98 (1976). The idea for partnership special allocations originated with the American Law Institute in 1954 and made its way into the Code as §704(b) in that year. The initial provision only limited these allocations to the extent that the principal purpose for the allocation was the avoidance or evasion of income tax. The report of the Senate Finance Committee that accompanied that 1954 provision for the first time used the term "substantial economic effect" in commenting on whether an allocation would be valid. This term also appeared in the original Regs for new subchapter K of the 1954 Code and contained six tests to evaluate whether or not a special allocation had substantial economic effect. The original language of 704(b) was amended by the Tax Reform Act of 1976 which strengthened the limitation by prohibiting any allocation which does not have "substantial economic effect." The amended section 704(b) provides that partnership bottom line income or loss (§702(a) (8)) or any income, gain, loss, deduction, or credit (provided for in §702(a)(1)-(7))may be allocated under the partnership agreement if the allocation has substantial economic effect.

Although cases decided prior to the 1976 amendment were nominally adjudicated under the 1954 language which only prohibited allocations that had a principal purpose of tax avoidance or evasion, fundamentally the test applied was "substantial economic effect". Thus even the early case law is useful in evaluating allocations under the current code provision and subsequent regulations.

The regulations for amended IRC §704(b) provide three ways that the special allocation will be respected:

1) the allocation can have substantial economic effect (as discussed subsequently);
2) the allocation can be in accordance with the partner's interest in the partnership taking into account all facts and circumstances; or
3) the allocation can be deemed to be in accordance with the partner's interest in the partnership under one of several special rules (discussed subsequently).

Of the three ways to validate a special allocation, the first method requiring the allocation to have substantial economic effect provides the most specific guidance. Under IRC Reg. § 1.704 (b)(2)(i) there is a two part test for evaluating the allocation:

1) It must have economic effect and
2) Be substantial.

ECONOMIC EFFECT

Any special allocation which creates a benefit or burden for a partner must in order to be valid assign all ultimate economic responsibility for the allocation to the partner receiving the benefit or burden.. There is a three part safe harbor provision which satisfies the economic effect requirement and will only satisfy that requirement if throughout the full life of the partnership all three criteria are met:

1) partners' capital accounts are maintained using book accounting rules:
2) at liquidation of the partnership or the liquidation of any partner's interest in the partnership, liquidating distributions will be based on the positive amounts in the partner's capital accounts; and
3) if a partner has a deficit balance in his capital account after liquidation, the partner is unconditionally required to make a contribution to the partnership to bring the deficit amount up to zero.

Part three of the three part economic effect safe harbor is open-ended in the amount of deficit restoration required of partners, however some risk can be avoided and the safe harbor provisions still met through an alternative requirement for what is essentially part three of the test. The alternative is satisfied if the partner who receives the special allocation is obligated to restore a limited amount of deficit and the partnership agreement contains a qualified income offset. Any special allocation to the partner cannot create a deficit larger than the amount the partner is required to restore. The ending balance in the partner's capital account should take into consideration adjustments, allocations of loss and deductions, and distributions that are reasonably expected to be made by the end of the tax year. A qualified income offset requires the partnership to allocate income to the partner who unexpectedly receives an allocation, adjustment, or distribution described above in an amount to eliminate the deficit as quickly as possible.

Note that if an allocation creates a deficit beyond the amount required to be restored, only the excess amount of the allocation will be disallowed and will be a proportionate amount of all special items allocated to the partner. Also a year-end change in the amount of deficit the partner must restore will not invalidate prior allocations if the ending deficit does not exceed the amount of deficit the partner must restore after the change.

There is a bit of relief for the partners under the "deemed" equivalence provisions. Even if the safe harbor tests are not met, an allocation will be deemed to have economic effect if at the end of the partnership tax year, a liquidation of the partnership would produce the same economic results to the partners that would have occurred under the safe harbor provisions.

The following examples and court decisions will illustrate the rules and criteria for economic effect discussed above.

Example 1

Assume an equal two person partnership formed by C and D by contributing $50,000 each. The partnership purchased a building for $100,000. The agreement is that C and D will share income (computed without depreciation deductions) equally. The cash flow and all depreciation will be allocated to C. Capital accounts will be maintained in accordance with the safe harbor rules except that upon liquidation of the partnership, distributions to the partners will be equal regardless of capital balance and no deficits will have to be made up. The first year depreciation of $25,000 is allocated to C. C has received the full $25,000 of depreciation for a deduction on his tax return but in liquidation, he would still get one half of the sale proceeds. He bears no economic consequence or risk of loss by deducting the full $25,000 depreciation amount. The allocation lacks economic effect and is disregarded.

A similar result was reached in one of the early court cases concerning special allocations. In *Orrisch* (Stanley C. Orrisch and Gerta E. Orrisch v. Commissioner 55 TC 395) the taxpayer and his partner owned and operated two apartment houses and under their unwritten partnership agreement they were to share equally the gains and losses from the operation of the apartments as well as the proceeds from any sales. A subsequent amendment to the partnership agreement allocated to Orrisch all depreciation deductions with the understanding that any gain attributable to the specially allocated depreciation was to be allocated to Orrisch. Orrisch put up two-thirds of the initial capital in the partnership. In the first three years of operation the partnership suffered losses attributable to accelerated depreciation deductions which were shared equally by the two partners. Orrisch had significant non-partnership income and partner Crisafi had non-partnership losses.

Early in year four, an amendment allocating all the depreciation to Orrisch was made. There was a gain charge back provision but proceeds from a sale that produced a loss were to be shared equally. The depreciation charges for years four and five along with half the partnership losses in years one through three left Orrisch's capital account with a deficit of $25,187.

In its opinion the court observed that Orrisch had large amounts of income which would be offset by the additional deduction for depreciation and that Crisafi, in contrast, had no taxable income from which to subtract the partnership depreciation deductions but the insulation of Crisafi from at least part of a potential capital gains tax was an obvious tax advantage. Orrisch argued that the allocation had substantial economic effect since the allocation was reflected in the balance of the capital accounts. The court countered by pointing out that an allocation has economic effect if the dollar amount of assets distributed to partners is independent of tax consequences and noted that the proceeds of the sale of the property would be distributed equally. Thus in this situation the only effect of the allocation would be a trade of tax consequences. Obviously if the property were sold at a gain the special allocation would only affect the tax liabilities of the partners and would have no other economic effect.

Now assume a variation (Example 2) on Example 1. The partnership agreement now provides that liquidation proceeds will be distributed according to capital account balances if liquidation occurs in the first five years of the partnership and then equally if liquidation occurs later. Special allocations under such an agreement would not have economic effect. There are two problems in this agreement: The requirement to liquidate on capital balances must be satisfied over the life of the partnership, and the provisions for deficits to be made up or the alternative to this requirement must be met.

Consider a further variation (Example 3) on Example 1 above. Assume the same facts in example 1 except that distributions will be based on partners' capital balances through out the life of the partnership and that the partnership agreement contains a qualified income offset in lieu of any deficit restoration as discussed above.

Example 1		
	C	D
Beginning Capital Balance	$50,000	$50,000
Less year 1 depreciation	(25,000)	0
End of year 1 capital balance	$25,000	$50,000

Under the alternative economic effect test, the allocation in year one has economic effect.

Example 4

Continuing the facts from Examples 1 and 3, suppose that the second year depreciation allocated to Partner C is $30,000.

Example 4		
	C	D
End of year 1 capital balance	$25,000	$50,000
Less year 2 depreciation	(30,000)	0
End of year 2 capital balance	$(5,000)	$50,000

The alternative economic effect test is satisfied only to the extent of $25,000 of the allocation. The remaining $5,000 of the allocation must be reallocated to Partner D. Under the partnership if the property were sold for $45,000 (its adjusted basis at the end of year 2) all the proceeds would go to Partner D. Therefore it is Partner D, not C, who bears the economic burden of the last $5,000 of year two depreciation.

A variation (Example 5) using the facts in Example 4 except that the partnership agreement requires Partner C to restore a deficit in his capital account up to $5,000. Because of the limited deficit make-up requirement up to $5,000 the full year 2 depreciation of $30,000 has economic effect because the deficit created in Partner C's capital account does not exceed the $5,000 maximum make-up obligation. It is interesting to note that the regulations say that the make-up requirement may be eliminated after the $5,000 is contributed by Partner C to the partnership and that the prior allocations remain valid. There are two other ways to meet the obligation to make up a deficit. A negotiable promissory note with a principal amount (to continue the facts above) of $5,000 can be made out to the partnership due upon the earlier of the end of the fourth year or liquidation of Partner C's interest. The same result could be achieved with a deferred obligation to contribute $5,000 to the partnership at the earlier of the end of the fourth year or liquidation of Partner C's interest. Both of the arrangements are acceptable under the alternative test and the year two allocation of the full $30,000 of depreciation has economic effect.

A last example (Example 6) with respect to economic effect: Assume partners L and M contribute $150,000 and $50,000 respectively to a general partnership which allocates all income, gain, loss and deduction 75 percent to L and 25 percent to M. The partnership maintains no capital accounts for the partners. L and M are liable under state law for 75 percent and 25 percent respectively of any partnership liabilities. The safe harbor provisions of the regulations are not met but the allocations have economic effect under the economic equivalence test. A similar situation was affirmed in *Dibble* (Phillip A. Dibble and Phyllis K. Dibble, et al. v. Commissioner 49 TCM 32). The Court noted that although the partnership agreement had deficiencies with respect to the safe harbor provisions, it still had economic effect because the provisions of the local state Uniform Limited Partnership Act would apply to require that liquidation distributions be made in accordance with the capital account balance and no partner would bear more than his share of the economic costs of the special allocation because the taxpayers maintained positive capital account balances.

SUBSTANTIAL

Not only must there be economic effect, the effect must be "substantial". Substantiality is the second part of the substantial economic effect requirement and to be substantial, there must be a reasonable likelihood that the allocation will affect in a material way the dollar amounts received by the partners independent of any tax effects. In addition, an allocation is not substantial if as a result of the allocation, the after-tax position of at least one partner is likely to be improved in present value terms compared to the position of that partner if the allocation were not made and there is a strong possibility that no partners' after tax position will be diminished in present value terms as a result of the allocation.

Shifting tax consequences, such as capital gains to one partner and an equal amount of ordinary gains to another partner, but not dollars, within a tax year is also not substantial. In particular, if as a result of a special allocation, the net increases and decreases in each partner's capital account would likely be about the same as would occur without the special allocation and the total tax liabilities of the partners considering their outside non-partnership tax items are less than they would have been without the special allocation then the allocation is not substantial.

Certain transitory allocations between partners from year to year are also not substantial. Thus if the partnership agreement provides an allocation to a partner in one year and there is a strong probability that subsequent allocations to the other partner or partners in subsequent years will offset the effect of the earlier allocation so that all partners' capital accounts are approximately the same amount that would have resulted without the special allocation and the total tax liabilities of the partners is less than it would have been without the special allocations, then the transitory special allocations are not substantial.

There is an exception to the transitory allocations rule called the five year rule. If at the time the original transitory allocation is made there is a strong possibility that the subsequent allocations will not have for the most part offset the initial allocation within five years, then the allocations are substantial.

Several examples which illustrate the application of the "substantial" criterion follow.

Consider Partners A and B (Example 7) who form a partnership to develop a new computer chip. A invests $2,500 and will work full time in the venture while B invests $100,000. The partnership will borrow any additional capital needed. The partnership agreement allocates all deductions for research expenditures and any interest expense on partnership loans to partner B. Additionally, partnership income or loss will be allocated 90percent to B and 10percent to A computed net of the deductions for research expenditures and interest expense until Partner B has received income allocations equal to the total of the research expenditures and interest expense previously allocated to him and his share of any taxable loss. Thereafter, partners A and B will share all taxable income or loss equally. The partnership agreement provides for cash flow from operations to be distributed equally and the partnership capital accounts and liquidation distributions follow the safe harbor provision for economic effect therefore, these allocations have economic effect. Because there is not a strong probability at the time the allocation became a part of the partnership agreement that the amount of research expenditures and interest expense would be largely offset by allocations of income to B, the economic effect of the allocations is substantial. The partners in this example assume a meaningful amount of risk because the actual outcome could not be reasonably forecast.

In contrast to Partners A and B (Example 7), no significant risk is assumed by Partners C and D (Example 8). Individuals C and D form a two person investment partnership which owns corporate bonds and tax-exempt bonds. For the foreseeable future, C expects to be in the 40 percent marginal tax bracket and D expects to be in the 15 percent marginal tax bracket. Based on the interest portfolio, the partnership expects to earn about $600 of tax exempt interest and about $600 of taxable interest. C and D made equal capital contributions to the partnership and have also agreed to share equally in the gains and losses from the sale of partnership assets and they have agreed to allocate income so that 90 percent of the tax-exempt interest goes to C and 10 percent to D and all of the taxable interest to D. The cash generated by the investments will follow the income allocations. The partnership agreement provides that the capital accounts will be accounted for under the safe harbor provisions, liquidation payments will be based on positive capital balances, and partners are obligated to bring any negative capital balance up to zero. The allocations have economic effect but are not substantial. If income is shared equally then C's after tax share of partnership income is $300 of tax-exempt income and $180 of taxable interest (net of tax) for a total of $480. D's after tax amount will total $555 ($300 tax exempt and $250 after tax, taxable interest). With the special allocation C will have $540 net of tax (90 percent of $600 of tax exempt interest) while D will have after tax income of $570 ($60 tax exempt and $510 from taxable interest). Thus, at the time the allocations became a part of the partnership agreement C expected to enhance his after-tax income and there is also a strong likelihood that neither C nor D will have their after tax income diminished.

Example 9 reaches a similar result. Equal partners E and F and the partnership all have a December 31 year end. The safe harbor provisions for economic effect are included in the partnership agreement. At the beginning of the year when the partnership is expecting §1231 losses, the partnership agreement is amended for one year only to allocate all such losses to E who expects to have no gains from § 1231 transactions in the tax year, and to allocate an equal amount of partnership loss and deduction of a different character to F who expects to have §1231 gains. Any partnership loss and deduction in excess of these allocations will be allocated equally to E and F. At the time the partnership agreement was amended it was very likely that the partnership would have losses other than §1231 losses that would equal or exceed the §1231 losses. The allocations have economic effect because of the safe harbor provisions but they are not substantial. The partners have assumed little risk with respect to the amount of losses each will receive. They have really only altered the amount of taxes that would otherwise be paid. To paraphrase the Regulations, because there is a strong likelihood, at the time the allocations became a part of the partnership agreement, that the net increase and decrease to E's and F's capital accounts will be the same at the end of the tax year as they would have been without the allocations, and that the total taxes paid by E and F for the year will be less than they would have been without the allocations, the allocation is not substantial.

Finally, Example 10 illustrates transitory allocations and an exception to the general disallowance of such transitory allocations under the 5-year rule. G and H form a general partnership to buy and lease machinery. Partners and partnership have a December 31 year-end and each partner invests $200,000. The partnership borrows $1,600,000 and with the $400,000 of invested capital purchases $2,000,000 of equipment to lease. The partnership agreement provides that capital accounts are maintained in accordance with the economic effect safe harbor rules. Liquidation proceeds will be based on positive capital account balances and negative capital accounts must be restored. The partnership agreement also stipulates that:

1) partnership net taxable loss be allocated 90 percent to G and 10percent to H until the partnership begins to produce net income and then 90 percent of net income is to be allocated to G and 10 percent to H until income equal to any previous loss allocated to G has been achieved;
2) all further partnership net income or loss is to be shared equally; and
3) cash flow from operations is to be distributed equally.

The partnership leases the equipment to a financially strong corporate lessee for a 12 year term. The partnership expects losses in years one through five of $200,000, $280,000, $160,000, $140,000 and $120,000 respectively. Generally when the income/loss stream is very predictable (little risk) the allocation is treated as insubstantial. The interest expense and principle payment is scheduled, the lease payments are prescribed by contract, the lessee is a strong company unlikely to go bankrupt, and the depreciation amounts are known from the schedule. However, because at the time of the allocation provisions, it was highly likely that the net losses in years one through five would not be largely offset by net income within five years, the allocation is substantial. This is determined on a first-in, first-out basis. The year one loss for example will not be offset until years six, seven, and eight. The year five loss will not be offset until years 11 and 12. The five year rule essentially says that offsets to be received beyond five years in the future really are not very predictable and the risk thus assumed makes the transitory allocation substantial.

The essentials for developing a special allocation that is bulletproof from IRS attack are now laid out. There have been no court cases involving questions of substantiality. The assumption is that taxpayers have not designed special allocations which obviously are not substantial and that the IRS has not been aggressive in challenging special allocations with respect to substantiality. From the previous examples, the substantiality test can be met so long as the ultimate benefits cannot be reasonably predicted. That means avoiding year-end allocations always and one year allocations generally. Based on the number of cases litigated, the great stumbling block in providing for successful special allocations has been complying with the economic effect criterion. The safe harbor provisions offer the easiest path to satisfy the economic effect test. This is certainly true for partnerships in those states which have adopted the Uniform Partnership Act. A particularly attractive solution is the safe harbor with the alternative to part three of the provisions which limits a partner's deficit responsibility in conjunction with a gain charge-back arrangement. Following the guidelines as developed and discussed makes the tax of §704(b) special allocations predictable and therefore an attractive tool in partnership tax planning.

HEALTH SAVINGS ACCOUNTS: A WAY TO HELP PAY FOR HEALTH CARE COST

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ABSTRACT

The rise of Health Savings Accounts is heralded by the growth in the number of participants. During its first year, fewer than a half million citizens took advantage of them. By 2007, 3.2 million participated. Currently, the Treasury Department projects that between 25 to 30 million people will help pay for their health care costs with funds in Health Savings Accounts. This report provides an overview of the costs and benefits of Health Savings Accounts (http://www.ustreas.gov/offices/public-affairs/hsa/pdf/fact-sheet-dramatic-growth.pdf)

INTRODUCTION

Health insurance is the largest line item in our budget, with the exception of payroll. It is more than rent, computer equipment, utilities, errors and omissions insurance, liability insurance, or supplies. And, bear in mind, health care benefits are in addition to the costs of retirement contributions, sick leave, vacation, and other benefits. Our annual benefits package exceeds $10,000 for each employee. With twenty-five full-time employees, a quarter of a million dollars is committed to benefits before one cent is paid in salaries and overhead. For a small professional services firm, this is a breath taking amount. This report provides an overview of the costs and benefits of Health Savings Accounts.

THE CASE FOR HEALTH SAVINGS ACCOUNTS

Employees want health benefits and employers recognize that a benefits package, including health insurance, is key to hiring and retaining competent people. However, health care benefits have become increasingly expensive. Over the past five years, health insurance premiums for our employees increased on average more than twenty percent each year. 2008 was a better year than most: the projected increase is *only* eight percent. Therefore, the opportunity to reduce costs with the advent of Health Savings Accounts is well worth our consideration. The primary cost savings arise from substituting a traditional Low Deductible Health Plan for a High Deductible Plan, which is supplemented with a Health Savings Account.

High Deductible Health Plans, however, have not been an option favored by employees. That may change with the availability of Health Savings Accounts and an understanding of its advantages. A Health Savings Account allows employees to set aside tax-deductible funds to pay for the insurance deductible as well as health care costs not typically covered by health insurance. Moreover, Health Savings Accounts provide incentives that encourage employees to conserve heath care resources. If patients pay some of their health benefits, they may monitor their own habits—eating more wisely, exercising, not smoking, drinking alcohol in moderation—and use health care resources more efficiently and effectively. Nevertheless, a concern remains. In the first years of a High Deductible Plan, the amount deposited in a Health Savings Account may be insufficient to cover the deductible.

THE ACT

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the Act), § Section 1201, created Health Savings Accounts. Of course, there are conditions that must be met to participate. The Health Savings Accounts must accompany a High Deductible Health Plan. The deductible must be at least $1,100 for individuals or $2,200 for families and the annual out-of-pocket expenses cannot exceed $5,600 for an individual or $11,200 for a family. These amounts include the deductible and co-payments, but not premiums.

Contributions to Health Savings Accounts are tax deductible, grow tax-free, and are immediately vested. Amounts not used for medical bills stay in the account and grow tax-free to cover future medical bills or, when the time comes, to supplement retirement benefits. Even after the owner of a Health Savings Account is no longer covered by a High Deductible Health Plan, money in the account continues to be tax-free as long as it is used for medical expenses.

Although a major concern is the risk of self-insurance, high deductibles have a potential cost with established contractual limits. Major health problems and the accompanying losses are still covered by the High Deductible Health Plan. Therefore, given the benefits, employees and employers may be willing to accept the risk compared to alternatives, including employers either paying less of the premium for health insurance coverage or dropping coverage altogether.

HOW HEALTH SAVINGS ACCOUNTS WORK

Anyone under 65 who purchases a High Deductible Health Plan can open a Health Savings Account. Individuals can buy a High Deductible Health Plan or have such plans through their employers. Likewise, contributions to a Health Savings Account may be paid by employees and/or employers. Employers' as well as employees' contributions to Health Savings Accounts are deductible from income. Unlike other tax breaks, there are no personal income limits on who is eligible. Contributions to a Health Savings Account are tax-deductible only if deposited on or before April 15. However, contributions need not be made in a lump sum or even on a regular basis.

Furthermore, unused Health Savings Account balances can roll over from year to year and continue to grow tax-free.

As with other tax sheltered payments, restrictions affect participation in Health Savings Accounts. For example, according to Revenue Ruling 2004-38, combining a prescription drug card with a High Deductible Health Plan will disqualify the policyholder from participating in a Health Savings Account. Note that the limitations tend to be in the nature of what is covered by the High Deductible Health Plan rather than collateral or additional insurance. For example, workers' compensation, tort, property, or similar insurance identified by Federal regulation, does not prevent participation in a Health Savings Account. So, insurance for a "specified disease or illness" ("a cancer policy") or insurance paying salary replacement for a fixed period of time does not make a person ineligible for a Health Savings Account.

CONTRIBUTION REQUIREMENTS

Restrictions are applicable to contributions, too. Each year individuals or their employers may contribute an amount of the deductible up to $2,900 for singles and $5,800 for families. Someone who is at least 55 years old can invest an additional $900 in 2008 and an additional $1,000 in 2009. Employees can decide how much to contribute to their accounts and can replenish used amounts throughout the year.

An important cautionary note to employers is that if they make the contributions, they must be "comparable." "Comparable" contributions require paying either the "same dollar amount or the same percentage of each employee's deductible" (www.treas.gov/offices/public-affairs/hsa/faq_employer-participation.shtml#hsa5). Contributions cannot be computed on the basis of an employee's income. If contributions are not "comparable," the employer is subject to penalties.

DISTRIBUTION REQUIREMENTS

The money deposited in a Health Savings Account can be withdrawn by check or debit card to pay medical bills. Participants appreciate the fact that funds from a Health Saving Account can be used to pay costs like dental and vision which are not covered by typical heath insurance policies. Funds from Health Savings Accounts can also be used for preventive care. While the statute does not define "preventive care", IRS Notice 2004-23 provides some "safe harbor" "preventive care items" including "periodic health evaluations, routine pre-natal and well-child care, tobacco cessation programs, obesity weight-loss programs, and a wide array of screening services", such as "cancer, diabetes, mental health, and metabolic and nutritional conditions."

Because funds paid into a Health Savings Account are immediately vested, an employee can continue to use the resources if s/he changes employment or is no longer covered by a High Deductible Health Plan. If not used, the funds grow tax-free until death or when the employee is eligible for Medicare. At that time the funds can be withdrawn without penalty.

If funds are inadvertently used for something not permitted by regulations, no tax penalty is incurred as long as the amount is repaid to the Health Savings Account. However, if a mistaken distribution is not repaid or if funds are intentionally used for something other than qualified medical expenses, the funds are taxed as ordinary income and subject to a 10% penalty. No penalties are incurred regardless of how the money is used if it is distributed after the death or disability (within the meaning of Code Section 72(m)(7)) of the Health Savings Account owner, or after they reach the statutory age for Medicare eligibility.

HOW TO IMPLEMENT A HEALTH SAVINGS ACCOUNT

Once a High Deductible Health Plan is in place, a Health Savings Account can be established at any financial institution—a bank, for example. There are a variety of investment vehicles for Health Savings Accounts including saving accounts, mutual funds, and stocks and bonds. As a general rule, except for a common trust managed by a financial institution, funds contributed to a Health Savings Account should be maintained in a separate account. Bear in mind that in setting up an account and maintaining records, individuals, not their employers or the Health Savings Account custodian, are responsible for maintaining records to show that Health Savings Account funds are used only as permitted by law and regulation.

CONCLUSION

For self-employed and small to medium sized businesses, traditional low deductible health insurance premiums have become prohibitively expensive. A High Deductible Health Plan combined with a Health Savings Account may provide a cost-effective alternative. Health Savings Accounts offer 1) lower health insurance premiums, 2) lower taxes, 3) an incentive to conserve health care resources, and (4) the potential of more cash at retirement.

If employees participate in and share the costs of a High Deductible Health Plan/Health Savings Account, they should more fully appreciate the costs of insurance, the benefits of preventive health care, and its effect on business' productivity—or so employers and lawmakers hope. This in turn should help contribute to fewer health-related losses, reduced expenses to the business for down time or employment of temporary help. A further consequence, therefore, may be higher profitability—or so employers hope. The success of High Deductible Health Plans/Health Savings Accounts is yet to be seen, but they have potential that is worthy of consideration.

As with any new tax incentive, compliance has numerous exceptions and limitations. Failure to comply with the statute and IRS guidance may result in contributions becoming taxable, along with penalties. This report provides an overview of High Deductible Health Plans and Health Savings Accounts. Health Savings Account Notice 2004-50 (http://www.benico.com/Laws/HSA_notice_2004-50.pdf) may help establish tax compliant Health

Savings Accounts. For more details about Health Savings Accounts also see, www.treas.gov/offices/public-affairs/hsa/pdf/HSA-Tri-fold-english-07.pdf

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HEALTH INSURANCE COVERAGE AMONG THE PRIVATELY- AND SELF-EMPLOYED

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ABSTRACT

According to NFIB National Small Business Polls, the cost of health insurance is the leading problem faced by small business owners in the United States. As a result, many self-employed people forego coverage. This, in turn, can lead to a poorer state of health if the cost of medical care influences the uninsured person to decline to seek medical attention when needed. Through the analysis of data from the 2007 March Supplement to the Current Population Survey, this study examines the proportions of privately- and self-employed people who do and do not have health insurance. Not surprisingly, the results show that the self-employed whose businesses are unincorporated are the least likely to be insured. The incorporated self-employed, however, were even more likely than privately-employed workers to have health insurance. This is an important problem because, as shown in this study, people without health insurance are more likely to have poorer self-reported states of health.

INTRODUCTION

"If you don't have your health, you don't have anything."

The United States is the only industrialized country that does not guarantee access to health care through socialized medicine, a single-payer insurance system, or other similar program (Battista & McCabe, 1999; Gladwell, 2005; Vladeck, 2003). Between 2005 and 2006, the overall percentage of uninsured people rose to 15.8% from 15.3%, representing a rise from 44.8 million to 47.0 million people (US Census Bureau, 2008).

At the same time, the number of insured people increased from 249.0 million in 2005 to 249.8 million in 2006, of which 201.7 million had private health insurance. Overall, employer-sponsored health insurance covered 59.7% of people in 2006, down from 60.2% in 2005. The percentage covered by Medicaid was 12.9% (38.2 million people) in 2006, statistically unchanged from 2005.

A lack of health insurance is important to both individuals and society because people without coverage are less likely to obtain needed medical care, which ultimately leads to more expensive treatment when the ailments are eventually treated (Battista & McCabe, 1999; Gladwell, 2005, Hadley, 2007; Sack, 2007). This problem is especially felt among small business owners and their employees as they are most likely to be among the uninsured (Holahan & Cook, 2008; Sutton-Bell & Fields, 1991; Wilcox, 1992). The following study investigates this important issue by first comparing the proportions of self-employed or privately employed (as determined by their "class of worker" classification) who do and do not have health insurance and then examining respondents' self-reported states of health.

HEALTH INSURANCE COVERAGE AMONG SMALL BUSINESSES

The rapidly increasing cost of health insurance has been repeatedly named the primary problem among small business owners as health care costs have seen double-digit increases in the past few years (Phillips, 2004). This has led to fewer and fewer small business owners offering employees health insurance. Thus, the self-employed and small business owners are the most likely to feel the effects of high health insurance premiums. One result is that they and their employees are less likely than other workers to have employer-sponsored insurance and more likely to be uninsured, especially in companies with fewer than five employees (Holahan & Cook, 2008; Sutton-Bell & Fields, 1991; Wilcox, 1992). A small business poll conducted by the NFIB found that less than half (48%) of the smallest firms now offer insurance compared to 56-58% in previous years (Phillips, 2004, p. 7).

In a study of small firms employing 1 to 249 workers, several factors were found to be related to whether employees were offered health insurance (Morrisey, 2003). While 91% of the business owners in this survey had health insurance, this did not necessarily translate into benefits for employees as approximately half offered insurance. Practically none of those owners who lacked insurance offered health benefits to employees. Breaking the data down by size of firm, Morrisey found that among business owners with 20 or more employees 98% had their own insurance coverage. Of these, 78% then offered insurance to their employees, compared to 41% of companies with fewer than 10 workers.

The age of the business was also an important factor in that only 35% of businesses less than 2 years old offered employees insurance, while this percentage rose to 45% among those aged 2-5, and to 52% for firms 11 years old or older (Morrisey, 2003). There was a slight dip to 41% among companies in business between 6 and 10 years. Similarly, the average wage played a role with insurance coverage decreasing as the proportion of low-wage (earning less than $20 per hour) employees increased. Among companies in which at least three-quarters of employees were low-wage, 42% offered health insurance. However, among those in which at least three-quarters earned more than $20 per hour, 70% offered this benefit. This is consistent with other studies that have found that in firms with lower average wages, health insurance benefits comprise an increasingly larger portion of the compensation package, making it less likely that such coverage will be offered

(Formisano, Schwartz, Neale, Galanter, Grossman, & Geis, 1990; Hirschberg, 2001; Holahan & Cook, 2008; Wilcox, 1992).

The primary reason health insurance is not offered is usually cost (Holahan & Cook, 2008; Kathawal, Elmuti & Roszkowski, 1993; Morrisey, 2003). A study of small firms in Illinois found that the high cost of insurance (often related to a lack of group coverage availability) combined with insufficient company profits were the major reasons given for not offering health insurance (Kathawala et al., 1993) Similarly, a survey of Florida small business owners without insurance found that over 60% of employers who did not offer health insurance as a benefit believed they would have difficulty accessing a group rate plan because they did not have enough employees (Holahan & Cook, 2008). This may, however, be a moot point as nearly 20% believed that providing a group plan would present too much of an administrative burden.

In a study in which Mulkey and Yegian (2001) hoped to find that small business owners over-estimated the cost of offering employees health insurance, it was shown that small business owners actually underestimated the cost by a significant margin. This means that even if employers sought insurance, they would be unlikely to subscribe to these plans. Mulkey and Yegian were also disappointed that they were unable to find a link between offering health insurance and improved business outcomes (increased productivity, reduced employee turnover, lower absenteeism, less workers' compensation cost).

These findings that do not confirm the link between offering health insurance coverage and improved human resource outcomes might be disputed by the 63% of small business owners who believe that this benefit is useful for recruiting and the 48% who believe it reduces turnover (Morrisey, 2003, p. 8). Increasing employee productivity, responding to competitors' benefits, sheltering income from taxes, providing for sick employees and their dependents, and obtaining personal coverage as a part of the plan were reported to be major reasons for offering insurance. However, a majority (78%) of these small employers who offered health insurance did so "because it's the right thing to do." The idea that there is virtue in offering employees health insurance is indeed defendable when the negative health effects associated with a lack of insurance are examined.

HEALTH AND HEALTH INSURANCE

Many people without health insurance forego medical care they feel they cannot afford it (Baker, Sudano, Albert, Borawski & Dor, 2001; Battista & McCabe, 1999). As stated by a man interviewed by Sered and Fernandopulle in their study of America's uninsured people, "if I had insurance, I would've went [to the doctor], because I know I could get treatment, but when you can't afford it you don't go…you just say, 'I can deal with the pain' " (in Gladwell, 2005, p. 2). In a study published by *JAMA,* Hadley (2007) concluded that the uninsured were less likely than people with health insurance to receive medical care (including immediate and follow-up care) after developing new chronic conditions or suffering injuries. Logically, those without insurance are more likely to have health problems (Ayanian, Weissman, Schneider, Ginsburg & Zaslavsky, 2000). Specifically, their breast, larynx, and mouth cancers tend to be discovered at later stages, making these maladies more difficult to treat (Sack, 2007). This lack of care perpetuates high costs in the health care industry as serious ailments become more expensive to treat, and the uninsured turn to the emergency room as a last resort (Hirschberg, 2001). As the cost to treat patients rises, so do health insurance premiums, leading to high numbers of uninsured people, resulting in higher treatment cost, and thus creating a vicious cycle. In the end, both generally poorer health and increased incidence of health problems lead to higher health costs (Gohmann et al., 2008).

A study by the Commonwealth Fund (2006) found that only 11% of working-age adults who shopped for health insurance ultimately bought coverage. Of those who remained uninsured, 58% said an affordable plan was very difficult or impossible to find. Approximately three-quarters of the uninsured who are ill state that they have difficulty obtaining and paying for medical care (Battista & McCabe, 1999, p. 2). Indeed, "the leading cause of personal bankruptcy in the United States is unpaid medical bills" (Gladwell, 2005, p. 2).

A common solution to the problem of affordability is health insurance with a high deductible, which makes the yearly premium lower. Such plans, however, can lead to problems similar to those experienced by the uninsured. While 54% of people with deductibles under $500 are very satisfied with the quality of their health, only 29% of those with deductibles over $1,000 are equally satisfied (Commonwealth Fund, 2006). While 75% of those with the lower deductibles experienced no problems in accessing health care (sought medical care when needed, obtained prescribed medications, saw specialists when needed, followed through with recommended tests or follow-up appointments), this proportion dropped to 56% among those with the $1,000 deductible.

While people in particular urban areas are likely to receive the best health care available in the world, "there are considerable pockets of the population for whom access to health care and the effects on health status are much more similar to those of poorer and less successful Third World countries" (Vladeck, 2003, p. 16). In fact, the death rate for the uninsured is 25% higher than for those with insurance (Gladwell, 2005). Clearly this is an important issue that relates not only to money, but to life and death. In the following section, data regarding health insurance coverage among the privately and self-employed are compared, as are the self-reported states of health.

METHODOLOGY, RESULTS, AND ANALYSIS

Date regarding health insurance coverage, class of worker, and demographic variables were gathered from the March 2007 Supplement to the Current Population Survey (CPS) via DataFerrett. These data represent a point-in-time estimate for the previous year, 2006 (Holahan & Cook, 2008). This study focuses not on the number of companies that provide health insurance, but on the reported coverage of individuals since many self-employed people do not employ any paid workers. Furthermore, a human's state of health is not an organizational, but a very personal, issue.

The variable "class of worker" (A_CLSWKR) was chosen to indicate whether respondents were privately employed, self-employed in an incorporated business, or self-employed in an unincorporated business. This study was limited to these three classifications and government workers, those who work without pay, and all others not fitting the three categories of interest were omitted. The two health insurance variables selected were HI, health insurance coverage through a current/former employer/union, and HI_YN, health insurance private coverage. Both are dichotomous yes/no variables. As shown in Table 1, those who answered "no" to HI form the population for HI_YN.

The "combined" variable was created by adding the number of people with employer-related insurance to the number with private insurance. The percentages of people in each category are shown in Table 2, which presents the data broken down by relevant demographic variables. Further analysis was completed by determining the number of people who were in the "no" category of the combined variable (no employer-related or private insurance) but were covered by Medicaid.
This did not change the results and were therefore excluded from the study.

Table 1: Number of People with Employer-Sponsored or Private Health Insurance

	Total	Yes	No
HI (Employer-Sponsored)	107,776,846	54,522,437	53,254,409
HI_YN (Private)	53,254,409	25,660,324	27,594,085
Combined	107,776,846	80,182,761	27,594,085

Chi-square tests were performed to examine the associations between health insurance status and class of worker, sex, and location, as well as combinations of these variables such as sex within metropolitan or non-metropolitan areas. Each test resulted in a statistically significant difference ($p<.001$) even when the differences in percentages did not appear to be very large. This could be partially due to the very large numbers of people (107,776,846 total) included in the study. Analysis of the data shows that while the majority of workers possess some form of health insurance coverage, some groups are much more likely to have this benefit.

In regard to the analysis of data by class of worker, grouping the self-employed together in one category would have yielded different results. While the self-employed as a single category (not shown: yes=70.4% and no=29.6%) would have had coverage at a rate very similar to the privately employed's 75% coverage, it is clear from the break-down that the incorporated are much more likely to have insurance and the unincorporated are much less likely to be covered. This is due in part to the high rate of private insurance coverage among incorporated self-employed people in addition to a fairly high employer-sponsored coverage rate. The unincorporated self-employed had much lower rates of being insured by either means. As a result, over one-third of the unincorporated self-employed were uninsured, compared to one-quarter of private workers, and only one-sixth of the incorporated self-employed.

Table 2: Percentage of People with Employer-Sponsored or Private Health Insurance						
	HI		HI_YN		Combined	
	Yes	No	Yes	No	Yes	No
Total	50.6	49.4	48.2	51.8	74.4	25.6
Private	54.4	45.6	45.2	54.8	75.0	25
-Male	58.1	41.9	36.4	63.6	73.3	26.7
--Metropolitan	58.0	42.0	36.1	63.9	73.2	26.8
--Nonmetropolitan	58.3	41.7	37.7	62.3	74.0	26
-Female	50.0	50.0	53.9	46.1	77.0	23.0
--Metropolitan	50.9	49.1	54.1	45.9	77.4	22.6
--Nonmetropolitan	45.6	54.4	53.2	46.8	74.4	25.5
Self-employed Inc	41.0	59.0	71.7	28.3	83.3	16.7
-Male	45.8	54.2	70.2	29.8	83.9	16.1
--Metropolitan	47.1	52.9	69.7	30.3	83.9	16.1
--Nonmetropolitan	39.0	61.0	73.0	27.0	83.5	16.5
-Female	28.2	71.8	74.6	25.4	81.8	18.2
--Metropolitan	28.9	71.1	75.0	25.0	82.2	17.8
--Nonmetropolitan	24.4	75.6	72.7	27.3	79.4	20.6
Self-employed Uninc	17.4	82.6	55.9	44.1	63.5	36.5
-Male	19.2	80.8	50.9	49.1	60.3	39.7
--Metropolitan	20.1	79.9	49.5	50.5	59.6	40.4
--Nonmetropolitan	16.6	83.4	55.1	44.9	62.5	37.5
-Female	14.4	85.6	63.8	36.2	69.0	31
--Metropolitan	15.4	84.6	63.6	36.4	69.2	30.8
--Nonmetropolitan	10.7	89.3	64.4	35.6	68.2	31.8

Further analysis of this group by sex showed that significant differences followed the same pattern. Incorporated self-employed men were insured at a rate 10% higher than privately employed men (83.9% vs. 73.3%) and over 20% higher than the unincorporated self-employed, of which almost 40% were uninsured. Except for the incorporated self-employed, among which men were somewhat more likely to have coverage (83.9% vs. 81.8%), women were more likely than men to have coverage, especially among the unincorporated self-employed (69.0% vs. 60.3%). This is consistent with Gohmann, McCrickard, and Deck (2008), who also found that men were less likely to have health insurance. The biggest differences were seen between employer-sponsored coverage for the incorporated self-employed (45.8% for men, 28.2% or women), private insurance among the privately employed (36.4% for men, 53.9% for women), and private insurance coverage among the unincorporated self-employed (50.9% for men, 62.8% for women).

Within the sexes, location-based differences were most evident among privately employed and incorporated self-employed women. Nonmetropolitan women in both of these work classifications were more likely than their metropolitan counterparts to be uninsured (25.5% vs 22.6%, and 20.6% vs. 17.8% respectively). In contrast, metropolitan unincorporated self-employed men were more likely than their nonmetropolitan counterparts to be uninsured (40.4% vs. 37.5). These unincorporated self-employed men in metropolitan areas were, in fact, the least likely to have insurance coverage.

Health insurance coverage is important because people without coverage are more likely to have poorer health as they often delay or fail to obtain medical care all together. To further examine the issue of health insurance among the privately and self-employed, data regarding self-reported health status were obtained and analyzed by class of worker (see Table 3). Each column shows the distribution of answers within class of worker/insurance coverage classification, adding up to approximately (given rounding errors) 100%.

Table 3: Heath Status by Class of Worker and Insurance Coverage Status

	Class of worker					
Health status	Private		Self-employed inc		Self-employed uninc	
	Yes	Non	Yes	No	Yes	No
Excellent	33.4%	24.4%	38.1%	30.8%	30.6%	24.6%
Very good	38.1	32.9	38.0	35.3	34.7	31.6
Good	23.3	32.6	18.0	27.9	24.2	31.4
Fair	4.6	8.4	4.9	5.0	6.2	10
Poor	0.6	1.8	1.0	0.9	1.2	2.4

Two trends are immediately clear from initial inspection of the data. First, the vast majority of people feel their health is good, very good, or excellent. Second, people who answered to "no" to questions regarding health insurance coverage were less likely to be in the excellent category and more likely to be in the lower categories.

The incorporated self-employed again come out on top as more people in this category claim excellent and very good health, especially among the insured. While 38.1% of insured incorporated self-employed people claimed excellent health, only 30.6% of the unincorporated self-employed and

33.4% of the privately employed enjoyed this level of health. Similarly 38% of the privately employed and incorporated self-employed had very good health, compared to 34.7% of the unincorporated self-employed, while the percentages among the uninsured were 32.9%, 35.3%, and 31.6% respectively.

While the "good" category is where the percentages of uninsured people in a category begin to be higher than the insured, the "fair" category most clearly shows the health effects of a lack of insurance coverage. A full 10% of the uninsured unincorporated self-employed reported fair health, with an additional 2.4% in the bottom "poor" category. Half as many of the insured were in the "poor" category, and 6.2% were in the "fair" category. A similar pattern was seem among the privately employed with 4.6% of the insured in the "fair" category, but 8.4% of the uninsured. Again, the incorporated self-employed were different from the other two worker classes as the percentages of the insured and uninsured in the lowest categories were practically equal.

Analysis of the data shows that, overall, being insured improves one's chances for having a better state of health. While this is good news for the insured, especially among the incorporated self-employed, over 27.5 million people are in the uninsured category, including the more than 3.4 million people in the unincorporated self-employed classification. In the United States as a whole, over 48 million people are uninsured (US Census Bureau, 2008).

CONCLUSION

The results of this study confirm those of previous ones (Holahan & Cook, 2008; Sutton-Bell & Fields, 1991) in which owners and employees of small businesses were found to be less likely to have employer-sponsored insurance and more likely than other workers to be uninsured. The lower percentages of insured people among the unincorporated self-employed is consistent with Morrisey's (2003) findings that smaller businesses were less likely to offer insurance because most of these business are likely to be have fewer than 10 workers. However, as shown by this research, the self-employed category is not homogenous. The self-employed whose businesses are incorporated tend to have both a high rate of insurance coverage and better self-reported health status evaluations than either the unincorporated self-employed or the privately employed.

Two suggested strategies for improving the situation are to allow both self-employed people and incorporated businesses to deduct 100% of their health insurance premiums and other medical costs, and grouping small businesses together so they can receive lower group rates (Kathawala & Elmuti, 1994). Decreasing coverage costs is probably the most effective way to improve the proportion of business owners and their employees who are covered by insurance because the price of insurance is the number one reason the uninsured choose not to buy it (Holahan & Cook, 2008; Kathawal et al., 1993; Morrisey, 2003). Of those who have insurance, the cost was identified as the primary problem facing small business owners (Phillips, 2004). Of course, socialized medicine or a single-payer system are also more radical options that would provide health care to the entire population regardless of their employer or employment status (Battista & McCabe, 1999).

Anecdotal evidence suggests the high cost of private insurance not provided through an employer at a group rate influences small business owners' behavior. Some delay starting businesses or completely abandon their dreams of entrepreneurship because they do not want to leave jobs in which they already receive benefits, believing they could not otherwise afford insurance. Others, having taken the plunge to start their own businesses, find it necessary to then take on other jobs with employers in order to access needed health benefits, especially when a family member becomes sick. Future research should compare US small business starts with those in countries where residents do not have to choose whether to buy health insurance coverage, as the cost of health insurance would assumedly not be a significant problem faced by small businesses in such nations. This could, in turn, lead to a higher rate of small business establishment and job creation.

Health insurance coverage is an important issue because, as shown in this study, the uninsured were more likely to have poorer self-reported states of health. This lends additional credence to the decision of small employers who provide health insurance "because it's the right thing to do" (Morrisey, 2003). Affordable access to medical care, associated with health insurance coverage, is essential to society in general as well because individuals as higher treatment costs effect everyone. People without insurance are less likely to seek medical attention before health problems become so severe that avoiding the doctor is no longer an option. (Battista & McCabe, 1999; Gladwell, 2005, Hadley, 2007; Hirschberg, 2001; Sack, 2007). Health ailments are much easier and cheaper to treat at earlier stages of development. As the old adage states, "an ounce of prevention is worth a pound of cure" and that ounce costs much less than the pound.

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TRANSFORMATION OF THE VIABLE BUSINESS STRUCTURES

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ABSTRACT

A significant movement has emerged whereby business practitioners have been provided with a buffet of business structures from which to select. This movement has transformed the business landscape by providing entrepreneurs with favorable tax treatment coupled with limited liability protection and increased flexibility. This article discusses the movement in order to provide the reader insight into the spirit of the movement to help predict future treatment based upon the gradual progression of the hybrid business structures.

INTRODUCTION

A significant movement has emerged whereby states are offering business owners and investors increasingly flexible and advantageous business structures while decreasing many of the rigid formalities associated with the traditional forms of organization in order to facilitate commerce. As a result, business practitioners are capitalizing upon the new hybrid forms of organization under which to conduct their business operations. The result has been to cloak the business practitioner with the protection of limited liability while eliminating many of the traditional impediments in order to promote commerce. In addition, the Internal Revenue Service (IRS) has shown increasing tolerance in permitting limited liability entities to retain the flow-through taxation attribute.

The purpose of this article is to review the evolution of the new hybrid business structures using it as a predicator to ascertain the future direction and treatment of the hybrid forms of organization. The article will first provide a brief overview of the two most important attributes associated with the selection of a business structure as well as the concept of piercing the corporate veil. The article will then provide an overview of the various business structures, in chronological order, to illustrate the movement. The article will conclude by summarizing the movement and dissecting the emergence of the newer hybrid forms of organization.

TAXATION

The first factor in determining the suitability of a particular business structure is the structure's method of taxation. Generally, there are two methods of taxation based upon the business structure. The first method consists of flow-through taxation, which occurs when the profit flows from the business directly to the investors (Altieri & Cenker, 2002). The investors are then taxed at their individual tax rate, using Form 1040. This method of taxation allows the investors to avoid a corporate level of tax, thus avoiding double taxation. The second general method of taxation is double taxation which occurs when the business is assessed a level of tax based upon its profits. The entity can then reinvest the profits back into the business, commonly referred to as retained earnings or the business can distribute the profits to the investors in the form of dividends. If the organization retains the earnings, the investors avoid paying personal income tax on the profits. If, however, the organization distributes the profits to the investors, the investors must pay income tax on the distributions, resulting in the second level of tax (Nadeau & Strauss, 1993)

LIABILITY

The second basic consideration is whether the investors and/or directors will incur personal liability for the debts of the organization. These debts can arise through either the breach of a contract or for the tortious conduct of the businesses agents. A tort is defined as a civil wrongdoing for which the law provides a remedy (Black, Nolan & Nolan-Haley, 1991). The person committing the tort, the tortfeasor, will incur direct personal liability for his own tortious conduct. Often times, however, the tortfeasor lacks the personal wealth to adequately compensate the injured party. As a result, the injured party is forced to seek restitution from an alternative party if the circumstances warrant it.

In order to provide the aggrieved creditor with sufficient resources to address the injury, the creditor is permitted to sue the business under the concept of respondeat superior. This concept is the attribution of liability to an employer for the action of the employee (Dobbs, 2000). Under this concept, the injured person imputes liability to the principal for the acts of the agent (Dobbs, 2000). A principal is the party that permits a person to act on its behalf while the agent is a person who has authority to act for the principal (Milliken Group, Inc. v. Hays Nissan, Inc, 2001). In its most rudimentary form, the concept of respondeat superior refers to the employee/employer relationship. The employee serves as the agent while the employer serves as the principal. If the employee has authority to act on behalf of the principal, an agency relationship is created (Dobbs & Hayden, 1997).

Once the agency relationship is established, vicarious liability is the tool by which personal liability is imputed to the principal. Vicarious liability involves imposing liability to the principal for the wrongful conduct of an agent (Kerl v. Rasmussen, 2004). In the organizational context, the business incurs vicarious liability for the acts of its agents, assuming the agent had the appropriate authority and was acting within his scope of employment (Fruit v. Schreiner, 1972). Once the aggrieved party vicariously imputes liability to the business, the creditor can attach the businesses assets in satisfaction of the debt (Fruit v. Schreiner, 1972). If, however, the business has insufficient assets to satisfy the aggrieved party, the creditor may be able to attach the personal assets of the investors. This issue is dependant upon the business structure of the organization.

LIMITED LIABILITY

Some forms of organization are endowed with a corporate characteristic known as limited liability. The limited liability attribute provides the investors and directors with a veil of protection shielding their personal assets from being attached to satisfy the debts of the business. As a result, the creditor would be prohibited from pursing the investor's personal assets to satisfy the remaining debt after depleting the businesses assets. If, however, the organization was operating as a business structure that does not posses the limited liability attribute, the investor's personal assets may be attached to satisfy any debt in excess of the businesses assets.

The limited liability attribute is of heightened importance in light of the anemic success rates of newly established businesses. According to a recent study, 66 percent of newly established businesses fail within the first four years of operation (Knaup, 2005). In other words, two-thirds of new businesses will cease to exist after four years of operation. Moreover, the current literature base establishes that entrepreneurs often use alternative means to finance the business in the start-up phase of the business life cycle, with 70 percent on the initial capital derived from personal savings, close family members and friends (Longnecker, Moore, Petty & Palich, 2006). With such a meek success rate, the attribute of limited liability plays a significant role in securing the entrepreneur's remaining assets.

PIERCING THE CORPORATE VEIL

While the concept of limited liability is an advantageous characteristic, it is not absolute. In certain situations the creditor can impose personal liability upon the investors of a limited liability entity. When this occurs, it is referred to as "piercing the corporate veil" (Oceanics Schools, Inc. v. Barbour, 2003). This issue is the most litigated aspect of modern corporate law (Rapp, 2006).

The underlying premise with respect to the imposition of personal liability to investors in a limited liability entity for the businesses debts is that, by legal fiction, the business is a separate and distinct entity and must be treated as such under all ordinary circumstances (Consumer's Co-op of Walworth County v. Olsen, 1988). While the presumption is in favor of limited liability and is not lightly disregarded, there are situations in which piercing the corporate veil is deemed appropriate. (Consumer's Co-op of Walworth County v. Olsen, 1988). A party attempting to disregard the corporate entity bears the burden of establishing, by a preponderance of the evidence, that the business is a mere sham and must be disregarded to prevent an injustice (Lascsak v. Hollingsworth, 2006). Only then will courts pierce the corporate veil (Fullco Lumber Co. v. Donat, 1994). The determination of whether the business is a mere sham is determined on a case by case analysis (Inryco, Inc. v. CGR Bldg. Systems, Inc., 1986).

The majority of states utilize a balancing test consisting of several factors in order to ascertain whether a corporation should be pierced. While each state uniquely articulates the factors, most states incorporate either expressly or implicitly a six-factor balancing test. The six factors considered when determining whether equity demands piercing the corporate veil include: (1) undercapitalization; (2) failure to observe corporate formalities; (3) absence of corporate records; (4) commingling of funds; (5) fraudulent misrepresentation; and (6) use of the corporation to promote fraud, injustice or illegality (Brevet Int'l, Inc. v. Great Plains Luggage Co., 2000).

If the plaintiff is successful in piercing the corporate veil, the aggrieved creditor will be able to attach the personal assets of the investors to satisfy the remaining debt in excess of the businesses assets (Inryco, Inc. v. CGR Bldg. Systems, Inc., 1986). While piercing the corporate veil was designed for the corporation, state courts have uniformly applied the same standard for the other limited liability entities (Bainbridge, 2005).

SOLE PROPRIETORSHIP

The oldest and most uncomplicated form of entity is the sole proprietorship. A sole proprietorship is simply an organization owned by one person (Black et al., 1991). The sole proprietorship serves as the default entity for businesses consisting of one owner. In other words, if a business, consisting of one owner, neglects to select a form of entity by filing the appropriate forms with the designated state filing agency, a sole proprietorship will be formed by default. As of 2004, over two-thirds of American businesses were formed as sole proprietorships (Miller & Jentz, 2004).

The sole proprietorship is considered an extension of the owner, as it lacks a separate existence independent of the sole proprietor. Since the proprietor is inseparable from the business, the proprietor has the authority to make all managerial decisions (Mallor, Barnes, Bowers & Langvardt, 2001). As the lone investor, all profits derived from the business are the sole proprietors. Moreover, the sole proprietorship is considered a flow-through entity, whereby the profits from the business flow directly to the owner. The taxes are then reported on the proprietor's Form 1040.

While these attributes help facilitate commerce and provide the entrepreneur with a simple business structure, it possesses several limitations restricting the viability of the sole proprietorship. First, as a mere extension of the owner, the entrepreneur retains personal liability for the debts incurred in furtherance of the business, exposing the entrepreneur to unlimited liability for the businesses debts. The aggrieved creditor would directly sue the proprietor as the sole proprietorship is a mere extension of the owner.

Secondly, the entrepreneur's ability to raise sufficient capital to adequately finance the venture is severely inhibited (Berger & Udell, 1998). Since the sole proprietorship is restricted to one owner, the entrepreneur is exclusively responsible for the capital contributions to finance the venture. While the entrepreneur is permitted to secure debt financing from outside sources, they often encounter difficulty in obtaining such financing. As a result, the primary sources of financing for the entrepreneur during the infancy stages of the business consists of seventy percent derived from personal savings, family and close friends (Longnecker at al., 2006).Moreover, it is estimated that half of all entrepreneurs utilize credit cards to compensate for short-term financing (Longnecker et al., 2006).

GENERAL PARTNERSHIP

In response to the above restrictions, entrepreneurs are permitted to engage in a joint venture with one or more investors, forming a general partnership. The general partnership was established in the United States in 1776, and prior to that enjoyed a rich tradition dating back to 2300 BC (Mallor at al. 2001). In 1914 the Uniform Partnership Act (UPA) was promulgated by the National Conference of Commissioners on Uniform State Laws (Mallor et al., 2001). The UPA and subsequent revisions serve as the model code, which can be modified or rejected by the state. In 1994, the Revised Uniform Partnership Act (RUPA) was adopted by National Conference of Commissioners on Uniform State Laws, replacing the UPA. The RUPA defines a general partnership as an association of two or more people working together to earn a profit (Uniform Partnership Act, 1997, §101, 6). The owners of the partnership are referred to as partners. This allows two people to combine resources to help ensure adequate capitalization of the partnership. In other words, it alleviates the financial burdens encountered with the sole proprietorship by allowing for the addition one or more partners.

Another characteristic of the partnership includes the ease of formation. The general partnership serves as the default entity for two or more individuals working together to earn a profit (Uniform Partnership Act §202, 1997). As a result, the partners are not required to file any documents to establish the partnership (Uniform Partnership Act §202, 1997). Moreover, while it is recommended that the partners draft a partnership agreement detailing the rights and responsibilities of the partners within the partnership, it is not required by state statute. If the partners fail to adopt a partnership agreement, the RUPA will serve as the default rules, unless the state has modified or rejected the RUPA.

Another attribute of the general partnership consists of the method of taxation. The partnership does not incur federal income tax on the profits. Rather, the partnership enjoys the flow-through method of taxation, similar to that of the sole proprietorship. As the profits are earned they flow through the partnership directly to the partners (Altieri & Cenker, 2002). While this method of taxation avoids one level of taxation, it does, however, possess a significant encumbrance as each partner is liable for self-employment taxes. The current rate for self-employment tax is 15.3 percent on the first $93,500 (IRS, SE Tax Rate, 2007).

The final advantage is the flexibility in the management of the partnership. As a general rule, the partners have unfettered authority to manage the partnership. While this can prove advantageous as it permits the partners to operate the businesses in furtherance of the partnerships mission, it does expose the partners to an increased level of risk, as it creates an agency relationship. The RUPA designates the partnership as an entity with a separate existence from the partners (Uniform Partnership Act, 1997, §201, a). As such, the partners serve as agents of the partnership (Uniform Partnership Act, 1997, §301, a). This provides the partners with the authority to bind the partnership to contracts and other obligations entered into on behalf on the partnership (Uniform Partnership Act, 1997, §301, a). As a result, the partnership is vicariously liable for the acts of its partners under the theory of respondeat superior. The authority of a partners can be restricted by filing a statement of partnership authority with the appropriate state agency, often times the Secretary of State (Uniform Partnership Act, 1997, §302, 2). By filing this document, investors are protected against unscrupulous partners.

While the partnership provides a simple structure under which to operate, it possesses several limitations which must be addressed by the partners. The risk associated with the broad authority of the partners is magnified as the partners are exposed to unlimited liability in satisfaction of the partnership's debts (Uniform Partnership Act §306, 1997). In a general partnership the partners are jointly and severally liable for the debts of the partnership (Uniform Partnership Act §306, 1997). Joint and several liability means that each partner is wholly liable for the entire debt of the partnership in excess of the partnerships assets (Black et al., 1991). To illustrate, if one or more of the partners commit a tort, the aggrieved party can vicariously sue the general partnership. Once the partnership is attached, the creditor can exhaust the assets of the business in satisfaction of the judgment. If the creditor's judgment exceeds the assets of the business, the creditor can attach the personal assets of all the partners up to the collective amount of the judgment.

C CORPORATION

The third traditional entity available to the entrepreneur is the C corporation. The corporation is a bedrock principle in the United States, dating back to 1776 when a corporation would receive a special charter from the state legislature, which was issued on a case by case basis through special action of the legislature (Mallor et al., 2004). These rare charters were eventually replaced in the late 18th century as states began to enact statutes permitting practitioners to incorporate their business (Mallor et al., 2004). Today, the corporation is a creature of statute as it derives its power and authority from state statutes.

The corporation is considered a fictitious entity, whereby it is considered separate from its investors. As a separate entity, the corporation is afforded certain constitutional rights, such as the rights to hold and sell property, to sue and be sued, and is entitled to due process under the Fourteenth Amendment (Model Business Corporation Act §3.02, 2002). While each state adopts their respective corporate statutes, the American Bar Association has promulgated the Model Business Corporation Act (MBCA), providing guidance for state legislatures. The MBCA was first promulgated in 1950, and has since undergone a series of revisions, including the most recent revisions of 1999, 2002, and 2005.

There are a couple advantages associated with the incorporation of a business. First, the shareholders are afforded limited liability protection. This shields the shareholders from incurring personal liability for the debts of the organization or for torts committed by the agents of the corporation (Model Business Corporation Act §6.22, 2002). As a fictitious entity, the corporation must hire agents to transact business on behalf of the corporation. Since the corporation is considered a separate entity from the shareholders, the corporation, not the shareholders, serves as the principal in this relationship. Accordingly, when an agent commits a tort within the scope of employment, the corporation will be vicariously liable under the concept of respondeat superior. This will permit the aggrieved party to attach the assets of the corporation. Even if, however, the assets of the corporation are insufficient to satisfy the judgment, the aggrieved creditor is barred from attaching the personal assets of the shareholders as the corporation possesses the coveted limited liability attribute.

Another advantage is the ability to raise substantial capital to adequately fund the venture, as the C corporation has the authority to sell different classes of stock (Model Business Corporation Act §6.01, 2002). This serves as an attractive attribute allowing the corporation to offer a wide array of investment opportunities to potential investors who can tailor their portfolio to meet their individual needs. In other words, a C corporation can sell common and preferred stock, as well as any other classification of stock authorized in the articles of incorporation, allowing both the corporation and investors the flexibility to tailor their investment to better suite their individual needs or portfolios (Model Business Corporation Act §6.01, 2002). In addition, the C corporation can offer an unlimited amount of stock, allowing it to raise substantial capital through stock offerings (Model Business Corporation Act §6.01, 2002).

One of the disadvantages associated with forming a C corporation includes complying with rigid formalities (Model Business Corporation Act, 2002). The C corporation must draft bylaws, elect a board of directors, and have annual board of director and shareholder meetings (Model Business Corporation Act §2.06, 2002). If the business fails to comply with these requirements, the shareholders are at risk of having their corporate veil pierced. When a creditor is successful in piercing the corporate veil, the limited liability protection is penetrated thus exposing the shareholders to personal liability for the debts of the organization.

A second disadvantage involves the method of taxation, as the C corporation is subject to double taxation (Nadeau & Strauss, 1993). First, the corporation must pay federal income tax on any profits earned. The second layer of tax arises when the corporation elects to pay dividends (Nadeau & Strauss, 1993). Since losses do not flow through to the shareholder, investors are prohibited from offsetting their personal income with corporate losses. While this method of taxation can serve as a deterrent for the entrepreneur, it does offer some advantages. Double taxation only occurs when actual dividends are distributed to the shareholders. If the corporation elects to retain the earnings, the individual shareholders avoid paying the second level of tax. Moreover, the detrimental effect is minimized when a shareholder receives qualified dividends, which are taxed at a reduced rate. In addition, the corporation is able to carry losses forward to offset future profits, or back to amend previous filings. Finally, the corporation has advantages relating to some fringe benefits unavailable to the flow-through entities.

TRANSFORMATION

Over the past decade a number of business friendly forms of organization have emerged to address the restrictions and shortcomings associated with the three traditional business structures. The trend has endured a process of transformation whereby the available business structures have gradually become increasingly flexible while providing preferential tax treatment coupled with liability protection.

LIMITED PARTNERSHIP

The limited partnership (LP) was the first business structure designed to afford the entrepreneur with the corporate attribute of limited liability while maintaining the flexibility and flow-through taxation found in the general partnership. The LP has existed in the United States since the early 1800s and is governed under the Uniform Limited Partnership Act (ULPA) (Miller & Jentz, 2004). This act has subsequently undergone a series of revisions.

The LP consists of both general and limited partners. The general partners are analogous to the partners in a general partnership. They are responsible for the management of the business, receive profits derived from the partnership and are jointly and severally liable for the partnerships debts, exposing them to unlimited liability (Revised Uniform Limited Partnership Act §404, 2001). In contrast, the limited partners serve as mere investors within the organization (Revised Uniform Limited Partnership Act §302, 2001). Their roles are limited to making capital contributions, and in return, share in the profits of the partnership. They are distinguished from the general partners as they lack the statutory authority to assist in the management of the organization. The limited partners, however, are permitted to serve as directors without exceeding their authority. Finally, the scope of their liability is limited to the amount of their capital contribution (Revised Uniform Limited Partnership Act §503, 2001).

The limited partnership has the option of electing to be taxed as either a corporation, or a flow-through entity. If the LP elects to be taxed similar to a corporation, the LP pays federal income tax on its net income. However, the partners are only liable to the extent of wages and distributions they receive. If the partnership elects to be taxed as a partnership, the partners report their shares of profits or losses on their individual federal income tax returns. The general partners are then able to deduct losses on their return, irregardless of the amount of their capital investment. In contrast, the limited partners may only deduct losses to the extent of their investment in the partnership.

S CORPORATION

In order to address the deficiencies of the LP, including the general partner's exposure to unlimited liability, a new form of entity was fashioned. The S corporation allows the entrepreneur to avoid double taxation while enjoying the benefit of limited liability (Godfrey, 2002). It significantly expands the scope of protection afforded to the investors by cloaking all shareholders with limited liability, as opposed to the LP which subjects at least one partner to unlimited liability. The S corporation differs from the C corporation only as it relates to the method of taxation. In other words, the distinction is made within the IRS code and not by state statute. For tax purposes, the S corporation is taxed under subchapter S of the tax code, while the C corporation is taxed under subchapter C. The S election permits the entity to be taxed analogously to a partnership's flow-through taxation, without being liable for self employment tax. (Godfrey, 2002).

While the S corporation was a novel concept, it is rigid and possesses restrictive regulations. For example, the number of shareholders could not exceed 35, thus restricting the ability of the entrepreneur to raise sufficient capital and stunted the growth of the business. Consistent with the emerging movement, the S corporation has been revised periodically. The first major revisions occurred in 1982 and 1996, respectively. The revisions of 1996 increased the permissible number of shareholders from 35 to 75; permitted S corporations to create employee stock ownership plans (ESOP's); allowed S corporations to own subsidiaries; and expanded the number of organizations that may own an S corporation (Small Business Job Protection Act, 1996). In 2004, the number of permissible shareholders was increased 100 (Godfrey, 2007). The S corporation has since become the most popular corporate form of entity (Godfrey, 2007).

LIMITED LIABILITY COMPANY

Even as the S corporation offers the unique combination of limited liability and flow-through taxation, it is encumbered with the rigid formalities associated with the traditional C corporation. As a result, the Limited Liability Company (LLC) was created, and epitomizes the movement toward providing practitioners with increasingly flexible business structures. The LLC is a hybrid entity combining the limited liability of a corporation with the flexibility and taxation comparable to the partnership.

Wyoming was the pioneer in the enactment of the LLC, creating the first statute in 1977 (Geu, 1992). Even though the LLC was enacted in 1977, it received little attention until the IRS issued ruling 88-76 verifying the LLC could retain its limited liability status while being taxed as a flow-through entity (Internal Revenue Service, 1988). In order to retain the limited liability attribute in conjunction with the flow-through taxation, the LLC was required to comply with the Kintner regulations (Goetzinger, Kirby & Nemec, 1999). The Kintner regulations consisted of a balancing test designed to ascertain whether the LLC was more analogous to a corporation or partnership. If it was determined the LLC contained more corporate characteristics, as opposed to partnership characteristics, it was taxed as a corporation. The corporate characteristic factors utilized in the balancing test included: limited liability; continuity of life; centralized management: and free transferability of interest (Goetzinger et al., 1999). In order to be taxed as a flow-through entity, the LLC could not possess more than two of the corporate attributes (Goetzinger et al., 1999).

The uncertainty associated with the balancing test dissuaded many entrepreneurs from forming their entity as an LLC. In 1997, the IRS promulgated the "check the box" regulations simplifying the procedure (Goetzinger et al., 1999). The new regulations permit the members to "check a box" as to the selected method of taxation, regardless of the number of corporate characteristics.

The LLC is a creature of statute, whereby its existence is based upon state statute. The investors of an LLC are referred to as members. In order to form an LLC, the members must file the articles of organization with the designated state filing agency as well as paying the appropriate filing fee (Uniform Limited Liability Company Act §202, 1996). After filing the articles of organization, the members should adopt an operating agreement, which closely resembles the bylaws of a corporation (Uniform Limited Liability Company Act §103, 1996). The operating agreement details the rights and responsibilities of the members as well as addressing the internal governance of the business (Uniform Limited Liability Company Act §103, 1996).

The LLC enjoys several advantages over the other traditional forms of entity. The first advantageous characteristic is the security of limited liability. The LLC, similar to the corporation, is considered a separate entity from its investors (Uniform Limited Liability Company Act §201, 1996). As such, the LLC serves as the principal within the agency relationship (Uniform Limited Liability Company Act §301, 1996). If an agent commits a tort, the LLC can be held accountable under the concept of respondeat superior (Uniform Limited Liability Company Act §302, 1996). The members, however, avoid personal liability for the LLC's debts (Uniform Limited Liability Company Act §303, 1996).

Secondly, the members of the LLC can elect to either be a member managed or manager managed entity (Uniform Limited Liability Company Act §404, 1996). As a member managed LLC, the members of the LLC are equally responsible for the management of the business (Uniform Limited Liability Company Act §404, 1996). In material contrast, an LLC that elects to be a manager managed LLC designats a manager to manage the organization (Uniform Limited Liability Company Act §404, 1996). The flexibility provides the entity with the option of centralization of management. Another key advantage is the reduction of formalities associated with the LLC (Geu, 1992). While the corporation must maintain annual meetings as well as drafting bylaws, the LLC avoids these stringent requirements.

LIMITED LIABILITY PARTNERSHIP

In 1991, the movement to form more advantageous and flexible business structures transcended professional barriers and provided members of professional service organizations a new form of entity. The limited liability partnership (LLP) is similar to the LP with respect to most of its attributes. The partners in both forms of organization are able to select whether they are to be taxed similar to a corporation or partnership, with the same rules applying as previously discussed. Moreover, the partners must file with the appropriate filing agency to form a LLP.

There is, however, one significant difference distinguishing the LLP from the LP. All partners of the LLP are cloaked with limited liability as opposed to the LP which exposes the general partners to unlimited liability (Uniform Partnership Act, §306(c), 1997). In other words, the partners within the LLP are not jointly and severally liable for the debts of the partnership. The exact coverage of protection afforded to the partners is determined by the generation of statutes in which the LLP is organized under.

There are three generation of statutes which are classified by the year they were enacted. In 1991, Texas became the first state to enact an LLP statute (Miller, 1997). These early statutes have become known as first generation statutes. The first generation statutes protects the partners from vicarious liability for the malpractice and negligence of a co-partner, as long as they were not personally negligent or in direct control of the negligent colleague (Miller, 1997). While affording the partner with some protection, it still exposed the partner to unlimited liability for other causes (Miller, 1997). The second generation statutes expanded the scope of protection to include debts arising from the misconduct of a co-partner, but only protected the partner against acts of negligence beyond their control (Miller, 1997). The second generation statutes are classified as those which were enacted between 1993 and 1995 (Miller, 1997). Finally, the third generations statutes were adopted which exempted partners from direct and indirect personal liability for all debts and obligations of the partnership. The third generation statutes include the statutes enacted after 1995 (Miller, 1997).

LIMITED LIABILITY LIMITED PARTNERSHIP

The Limited Liability Limited Partnership (LLLP) is a new form of partnership that has only been established in a few states. The purpose of the LLLP is to serve as a conversion for an existing LP. The structure is very similar to the LP in that there must be at least one general partner and one or more limited partners. The distinction arises with the liability for the general partner. While the LP only affords limited liability protection to the limited partners, the LLLP extends the limited liability protection to the general partner, making it analogous to the LLP.

STATUTORY CLOSE CORPORATION

The newest form of entity is the statutory close corporation, which provides additional attributes not permitted with the other forms of organization. The statutory close corporation possesses the prototypical corporate attribute of limited liability but reduces the formalities inherent in the traditional corporate statutes. The purpose of the statutory close corporation is to provide the practitioner operating a small business with the advantages of the corporate form of organization while dispelling with many of the corporate formalities.

In order to form as a statutory close corporation, the entity may not have more than a specified number of shareholders as mandated by the state. The current limitations vary, with some states restricting the number of permissible investors to businesses with fewer than 30 shareholders while others states increase the permissible number of shareholders to50.

In order to receive favorable taxation, the statutory close corporation can decide whether to be taxed under subchapter C or subchapter S of the IRS code. If the entity selects to be taxed under subchapter S, they receive the flow-through taxation thus avoiding the double taxation associated with the C corporation. The statutory close corporation electing to be taxed under subchapter S provides benefits to the entrepreneur unavailable with the LLC. When an entity makes an S election, the shareholders are not required to pay self-employment tax, which is currently 15.3 percent of the first $93, 500 of profit (Internal Revenue Service, 2007). In contrast, the members of the LLC are responsible for self employment taxes. If, instead, the entity anticipates retaining earnings, it can elect to be taxed under subchapter C, avoiding the assessment of personal income tax on retained earnings.

Table 1

	Limited Liability	Taxation	Formalities	Filing	Management
Sole Proprietorship	No	Flow-through	None	None	Owner
General Partnership	No	Flow-through	None	None	Partners
Limited Partnership	Limited Partners	Flow-through	Limited	Yes	General Partners
Limited Liability Partnership	Yes	Flow-through	Limited	Yes	Partners
Limited liability Limited Partnership	Yes	Flow-through	Limited	Yes	General Partner
Limited Liability Corporation	Yes	Election	Limited	Yes	Member or designee
Statutorily Held Closely Held Corporation	Yes	S or C	Limited	Yes	Investors
S Corporation	Yes	Flow-through	High	Yes	Board
C Corporation	Yes	Double	High	Yes	Board

ANALYSIS

Over the past three decades a significant movement has emerged providing entrepreneurs with an increasingly business friendly landscape by providing practitioners with a combination of traditional corporate and partnership attributes. Traditionally, the entrepreneur was restricted to either forming as a sole proprietorship, a general partnership or C corporation. Each of the traditional forms of organization possessed a significant encumbrance for the practitioner. The entrepreneur could choose a business structure providing flexibility and flow-through taxation, at the expense of limited liability. In contrast, the practitioner could elect a business structure providing a veil of protection for the investors and directors of the business. However, the practitioners would be subjected to double taxation and required to comply with rigid formalities to maintain the veil of protection.

In response to the limitations associated with each of the traditional forms of organization, a steady trend has emerged presenting investors with increasingly advantageous attributes designed to help facilitate commerce. The movement started with the enactment of the LP, which was the first entity designed to combine partnership and corporate attributes. The LP provides the limited liability veil to the limited partners, but still exposes the general partners to unlimited liability, while allowing the partners to elect the method of taxation (Revised Uniform Limited Partnership Act §303, 404, 2001).

While the LP was successful in combining corporate and partnership attributes, it was restrictive as to which partners received limited liability. As a result, the S corporation was approved in 1958, expanding the protections afforded to all the shareholders of the business. The S corporation is distinguished from the general partnership and LP in that it afforded limited liability protection to all the investors and directors of the organization (Model Business Corporation Act §6.22, 2002) Moreover, the S corporation eliminated the need to the investors to pay self-employment tax, an attribute unavailable in the partnership. The S corporation is distinguished from the C corporation only in terms of its tax treatment as it is taxed as a flow-through entity, thus circumventing the corporate level of taxation.

Even as the S corporation was the first organization to provide limited liability protection to all the investors in conjunction with providing the entity with the flow-through taxation, stringent requirements were imposed. Traditionally, the number of shareholders permitted to invest in the S corporation was limited to 35. However, the S corporation has undergone a series of revisions expanding the number of permissible shareholders. In 1996, the number of shareholders was expanded to 75, and in 2004 it was expanded to permit 100 shareholders (Godfrey, 2007).

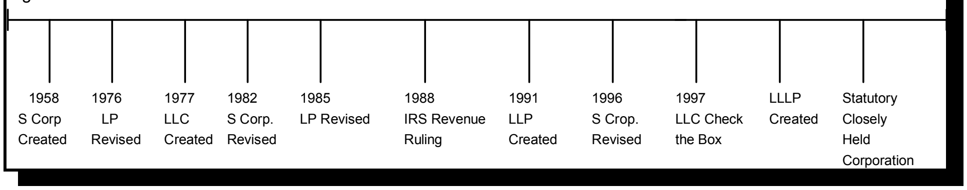
Even though the S corporation combines the coveted limited liability attribute for all investors with the flow-through taxation, it was still deficient to some practitioners as it restricted the number of shareholders permitted to invest in the business and maintained the rigid formalities required within the C corporation. As a result, Wyoming enacted the first LLC statutes in 1971, diminishing many of the shortcomings found within the S corporation, and eliminating the restrictions pertaining to the number of permissible investors (Geu, 1992).

The LLC provides all members of the business with limited liability protection, while allowing the members to elect the method of taxation. Moreover, the LLC statutes reduce many of the formalities and restrictions associated with the corporate form of entity. One of the diminished formalities includes the removal of entire level of corporate governance by eliminating the requirement of electing a board of directors (Goetzinger et al., 1999). Secondly, the members are not required to hold annual meetings (Goetzinger et al., 1999). The advantages associated with the LLC have transformed the business landscape. In 2002, there were more LLCs than general partnerships (Rapp, 2006). Moreover, in some states, the number of newly filed LLCs has surpassed the number of newly filed corporations (Winrow, 2007).

In 1991, Texas enacted the first LLP to provide practitioners of professional service organizations a business entity under which to practice. Since the initial enactment of the LLP, there have been significant modifications expanding the scope afforded to the partners determined by the generation of statute. The level of protection afforded to the partners was limited during the enactment of the early statutes, but steadily progressed during the enactment of later statutes. The steady increase in liability protection coincides with the overall movement.

More recently, two forms of organization have been enacted by a few states. The first is the LLLP which serves as a conversion for the LP. The second and more evolved of the two is the statutory closely held corporation. The closely held corporation diminishes the formalities traditionally associated with the corporation such as the requirement that the corporation maintain a board of directors and hold annual meetings. Moreover, the statutorily closely held corporation can elect the S status becoming a flow-through entity for tax purposes.

Figure 1



CURRENT WEAKNESSES NOT ADDRESSED

Even as it has become commonplace to merge corporate and partnership attributes in order to create hybrid organizations designed to provide practitioners with limited liability, flow-through taxation in a structure that is void of rigid formalities, there are still encumbrances that should be minimized in order to maximize the protections of the practitioner/investor. One of the overriding weaknesses relates to the tax consequences of the various forms of organization. Attorneys and accountants continually face a dilemma in deciding between advising a client to form as an LLC or S corporation. The LLC structure provides flow-through taxation, simplicity and limited liability. The members, however, remain liable for self employment tax which is currently at 15.3 percent. The S corporation, on the other hand, allows for flow-through taxation, eliminates the need to pay self employment tax and affords the shareholders limited liability. The disadvantage is that the shareholders must maintain the formalities associated with a corporation, including the utilization of a Board of Directors and annual meetings. The requirements are often difficult for entrepreneurs who fail to appreciate the importance of fulfilling the requirements. The failure to maintain the formalities is usually a factor taken into consideration when a creditor attempts to pierce the corporate veil.

NEW FORMS OF ORGANIZATION

In order to provide practitioners with a business structure which maximizes the tax benefit while continuing to provide limited liability protection in conjunction with limited formalities, new structures must be devised. The first possible structure would be to allow the LLC to elect to be taxed as an S corporation (S-LLC), the practitioner would be able to retain the advantageous flow through tax treatment without being subjected to self employment tax, while avoiding the stringent formalities, and retaining limited liability for the members of the entity. This form of organization would be limited to 100 members in order to comply with the current tax statutes. The advent of such a hybrid structure would effectively dispose of the S-corporation, as the benefits derived from forming an S-corporation could be achieved under a more flexible business organization.

A second from of organization which would address the shortcomings does exist in a number of states. The statutorily closely held corporation with an S election would permit the practitioner to form a business structure affording all the rights of a traditional corporation while reducing the associated formalities. The statutes reduce the formalities associated with the tradition corporation such as drafting bylaws, electing a board of directors and holding annual meetings. Such statutes provide corporate attributes such as limited liability while eliminating the formalities associated with the corporation. In addition, the shareholder can then elect to be taxed as an S corporation, which would provide the beneficial taxation in addition to simplicity and limited liability. While a few states offer the statutorily closely held corporation, the majority of states have yet adopted this structure.

CONCLUSION

The available forms of organizations have undergone a significant transformation. Traditionally, practitioners were limited to sole proprietorships, general partnerships and corporations. Each structure possessed distinct attributes such as limited liability with double taxation or unlimited liability with flow-through taxation. The result was to force the practitioner to decide between double taxation versus limited liability. During the next forty years the available business structures underwent a significant transformation. Today, the most common forms of organization possess both corporate and partnership attributes. Practitioners are now afforded structures designed to provide beneficial tax consequences while affording the investors limited liability protections and flexibility. Even though the newer hybrid business structures are experiencing immense popularity, the practitioner and consultant must remain cognizant that the hybrid forms of organization are still in the infancy stage. As a result, the judicial treatment of the newer business structures remains in question.

Even as corporate and partnership attributes have merged creating hybrid organizations, there are still weaknesses in the available forms of organization. One such weakness includes the requirement that the members of the LLC pay self employment tax. According to the Uniform Limited Liability Company Act, the LLC is considered an entity separate from the members. Moreover, in relation to the agency relationship, the LLC, as opposed to the members, serves as the principal in the relationship. As a result, the LLC is more similar to an S corporation. Accordingly, the LLC should have the option of being taxed as an S corporation, thus avoiding the requirements that the members pay self employment tax.

While the number of available forms of organization continues to increase, there remains insufficient research pertaining to the engine driving the change. In order to fully ascertain the direction of the movement, it is important to understand the forces promoting the newer hybrid business structures. According, future research should be conducted to ascertain how lobbying has influenced the available forms of organization as well as the types of interest groups that have successful lobbied for such change, such as small business interest groups, corporations and economic development organizations. These groups should then be compared and contrasted to gain a comprehensive understanding of the engine driving the change.

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ATTORNEYS AND THEIR USE OF TECHNOLOGY

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ABSTRACT

This manuscript provides a look at trial lawyers as micro-firm entrepreneurs, and at their decisions to adopt technology as an integral tool for their firms. Within the U.S., a significant number of trial attorneys are in micro-firms; organizations in which many of the functions of larger firms are handled by very few individuals. Day-to-day management decisions made in these micro-firms, as well as in entrepreneurial micro-firms in other industries can lead to an immediate feast-or-famine outcome.

To illustrate technology use by trial attorneys, data from a recent survey provides a glimpse at the factors that influence technology adoption by micro-firm attorneys. First, we discuss attorneys and the practice of law as a service-sector industry. Second, a brief review of literature illustrates entrepreneurial decision-making. Third, a discussion of practice-related literature illuminates the trend toward increased presentation technology adoption by attorneys, and the need to convey information during trials

Subsequently, a review of findings from the 2004 Louisiana State Bar Association Legal Technology Survey looks at the variety of technology tools in use by trial attorneys, and provides insight to their technology adoption and prioritization, followed by the conclusion.

INTRODUCTION

There is relatively little academic literature published about the business of law firms and attorneys. Speculation why that is the case can lead to an epiphany that this particular service-industry functions at its core upon the instinct, knowledge, motivation and creativity of its practitioners. These micro-firms have unique technology needs, and with few limitations enjoy a high degree of voluntariness in their decisions to adopt it. Off-the-shelf micro-computer technology is now regularly employed from the production of documents for introduction in the litigation processes, contracts, wills, negotiations and more, relegating the typewriter to a few specialized tasks. They use various levels of communications technology for keeping in touch with courts, clients and other attorneys. The use of technology for legal research as well as for personal tasks or even enjoyment demonstrates familiarity and comfort with it. In recent years, some courts have implemented paperless systems, making certain technology adoption scenarios less voluntary, as attorneys in those courts must file documents electronically. The adoption of presentation technology presents even more challenges for attorneys, as complex issues and scenarios impact its effectiveness and usefulness. Thus, the use of technology by attorneys varies widely.

METHODOLOGY

This research utilizes and combines two qualitative research procedures and methodologies found on the *United States Department of Veterans Affairs* web page "Methodological Challenge – Using Qualitative Research Methods":

Content analysis of documents

This is a non-intrusive form of research. This involves reviewing documents, memos or other pieces of written information for content and themes. By examining written word, the researcher is studying one type of communication that occurs in the selected sample.

Collection and analysis of other archival, administrative and performance data

This method also is non-intrusive. Information that has been previously collected, or secondary data, is reviewed to gain a better understanding into the topic. This information is part of the organization's history and can be a valuable key to understanding the past.

This manuscript examines content of professional or practice literature, given the lack of academic literature on the subject. The content of the specialized, industry-specific publications illuminate the common practices and state of practices within the business of the legal profession in general and trial lawyers specifically.

This manuscript further examines descriptive statistical data from a recent technology survey of the Louisiana State Bar Association. These observations, pared with the extracts from professional literature, provide an insight to the mindset of the entrepreneurial micro-firm lawyer.

REVIEW OF LITERATURE

Robbins and Coulter's (2005) textbook, *Management, 8th Ed*., stated, "Perception is a process by which individuals give meaning to their environment by organizing and interpreting their sensory perceptions. Research on perception consistently demonstrates that individuals may look at the same thing but perceive it differently" (p. 357). Michael Porter, in his book; *Competitive Advantage, Creating and Sustaining Superior Performance.* (1985) wrote, "Buyers will not pay for value that they do not perceive , no matter how real it may be" (p. 139).

Harlan, Christenson, and Vancil, (1975), stated, "Business administration is an art. While there have been rapid advances in scientific, professional management during the last half-century, successful business administration still requires an intangible best described as skill"(p. 31). This reinforces the idea that despite the fact that while many business decisions are made as the result of number-crunching and the advice of consultants and specialists, many business decisions are based upon the opinions of managers and little else.

Peter F. Drucker, in his 1974 book, *Management,* stated, "Perception, we know, is not logic, it is experience. This means, in the first place, that one always perceives a configuration. One cannot perceive single specifics. They are always part of a total picture" (p. 483).

Considering the research at hand, there is consideration of the validity of applying the comments from these stalwarts of management literature when examining the functions of a micro-firm. Further examination of literature reinforces that small firma are worthy of study and attention, as Metcalfe (2004), found that the modern emphasis on the small firm as, "the prototypical vehicle for entrepreneurial action, and more precisely the technology based firm" (p. 165). The decision-makers of small firms are drivers of decisions with managerial, economic, and financial bearing. Managers of small firms have, according to Metcalfe (2004) perceived a different view of the world, "a view that is the basis for differential economic action" (p. 167). "Entrepreneurs believe something nobody else believes, and do so with sufficient strength of mind to act upon the belief and commit economic resources to a business plan" (p. 167).

Challenging the business world through imagination, not calculation alone, entrepreneurs are innovators. According to Metcalf (2004) "It is on this distinction that our understanding of the entrepreneur rests; the entrepreneur as the individual who dares to act on the basis of thoughts not held by others, who challenges through imagination, not calculation alone, the foundation of their economic and social co-operation," (p. 168).

Many issues arise when examining the dynamics of small firm management. Hartman, Lundberg, and White, (1990), and others point out that the relationship between planning and decision-making is not well understood, and that many decisions appear to be intuitive. Adamides, E. D., Stamboulis, Y., & Kanellopoulos, V.. observe that while, "national culture is a macro-level variable, mental models operate at a micro-level' i.e. at the level of the individual." (p. 72).

Subsequently, the small or micro-firm entrepreneur is more prone to adopt technology when its value to the operation is clearly identified. The decision thus should be a comfortable one, and the technology is something either directly understood by the decision-maker or it is something that instinctively if not personally, the decision-maker feels comfortable using or adopting. The issue of the use of presentation technology by attorneys touches upon all of these factors.

LEGAL INDUSTRY LITERATURE

In his 1999 *Continuing Legal Education Online Seminar*, E. X. Martin, III, Attorney at Law stated:

> *No matter how believable your client's evidence is, you will not be successful in trial if the jury isn't listening. Computer generated forensic recreations and simulations are dramatic, persuasive, and can be used as demonstrative and scientific evidence in both civil and criminal cases. Recreations and simulations convey information more effectively, memorably, and persuasively than oral testimony alone.* (Para. 1)

This exposes the expectation by clients and jurors alike that they expect to see the modern tools employed to win their case. Litigation is not a show; it is about conveying a case to a judge or a jury. Successfully getting your point(s) across in a meaningful and credible fashion is crucial to a trial lawyer's success. Litigation involving science, technology, medicine, engineering, finance, etc. can be difficult for a lay jury to comprehend. Brinig and Gladson's (2000) *Developing and Managing a Litigation Services Practice* stated: "One of the most difficult skills to master is a clear presentation of a complex set of facts to an individual or group of people who are not financially sophisticated," (pg. 15).

In 1999, *TRIAL Magazine* featured an article by Frank Herrera, Jr. and Sonia M. Rodriguez: "Courtroom technology: tools for persuasion." They wrote:

> *To avoid boring jurors, trial lawyers must consider bringing sophisticated technology to court. We live in an age of images and an era of electronic media. As a society we no longer read newspapers, magazines, or books for in-depth information and discussion. Instead, we settle for cheap 30-second sound bites and glossy all in convenient, easy-to-swallow caplets.*
>
> *Accordingly, jurors get their news, politics, entertainment, and history from "people paid to arrange and rearrange the truth in its most. . . convenient pose." In the world outside the courtroom, jurors' ideas are being guided by talk-show hosts, captained by legal and political pundits, inspired by movie-of-the-week actors, and educated by public relations experts.*
>
> *Thus, a significant technology challenge for a an attorney then, is to avoid boring the jury while continuing to clarify the major themes of his or her argument and present potentially complicated evidence. To meet this challenge, lawyers have begun bringing technology into the courtroom.* Paragraphs 2-5

Therefore, the use of technology as a tool at trial is a special technology application that is unique to the business of the practice of law. Attorneys, particularly those who are plaintiff attorneys who have taken a case on a contingency basis, receiving no up-front fees or payments from the client, essentially must present a strong enough case to wither win or settle cases or they are out of business. Thus, the ability to convey information is essential, and presentation technology is emerging as a tool in the industry.

U.S. CENSUS BUREAU INFORMATION

The information from the U.S. Census Bureau illustrates the latest business data on the Legal Service Sector in both the United States and the State of Louisiana.

The Legal Service Sector in the United States and in the State of Louisiana

The United States Census Bureau publishes business data by sectors on the basis of the North American Industry Classification System (NAICS). NAICS Code 541110 Offices of lawyers (includes law firms, offices and practices). The 1997 report from the U. S. Census Bureau (p. 12) reports these statistics for NAICS Code 541110:

Within the entire United States	
Number of establishments:	165,757
Annual Receipts:	$122,616,890,000
Number of paid employees:	956074
Within the State of Louisiana	
Number of establishments:	3,612
Annual receipts:	$2,033,447,000
Number of Paid Employees:	17,764

THE 2004 LOUISIANA STATE BAR ASSOCIATION'S LEGAL TECHNOLOGY SURVEY

This study was primarily conducted in courtrooms throughout the State of Louisiana. The study focused upon gatherings of practicing attorneys. In most circumstances, the researcher made appointments with judges throughout the State of Louisiana and presented the survey instrument and letter of introduction from the Louisiana State Bar Association. Within a span of three months, 487 completed research instruments were collected in these court-appearance sessions. The number completed in a single day was approximately 10.

For the purpose of simplicity, the 2004 Louisiana State Bar Association's Legal Technology Survey will be hereafter referred–to as the "*2004 LSBA Survey*."

The data from the 2004 LSBA Survey, portions of which are discussed in this manuscript, were published by Lambert (2006a) in the unpublished *Report of the 2004 Louisiana State Bar Association Legal Technology Survey* and in the unpublished dissertation: Lambert, (2006b).

Economic and Management Factors Affecting The Adoption of Presentation Technology by Law Firms

According to a report obtained via email from the organization, there were 16,744 members in the Louisiana State Bar Association as of June 1, 2004, with attorneys in every parish in the State of Louisiana. With a population of 16,744 and a sample size of 487, the confidence interval is 4.38% of the measured value at a confidence level of 95%,

2004 LSBA SURVEY: LA ATTORNEY DEMOGRAPHIC INFORMATION

Gender

According to this study, the majority of attorneys in Louisiana are male. Of the 454 who replied to the question regarding gender, 21.8% indicated that they were female, while males at 78.2% were the clear majority.

Ethnicity

It is not uncommon in Louisiana to find many people who consider themselves multi-ethnic. As such, respondents could provide yes/no answers to their ethnicities, and answers in multiple categories were permitted. 86.4% answered "yes" to Caucasian, while 6.4% answered "yes" to African-American. Much smaller numbers were obtained in other categories.

Age

Attorneys were asked their ages. Of 487 who participated in the survey, 27 did not answer the question of age. Of the 460 who did reply, the age distribution is illustrated in Table 1:

Table 1: Ages of attorneys responding to the survey

Age Bracket	Percentage
Under age 30	6.5%
Ages 30-39	28.9%
Ages 40-49	28.3%
Ages 50-59	28.3%
Age 60 or older	8.0%

2004 LSBA SURVEY: ATTORNEY PRACTICE AREAS

In law there are attorneys who have a general practice, while others specialize in a limited number of fields. The total number of responses out of 487 completed surveys for each of the practices are shown below in Table 2, and the percentages are of those numbers who responded. Primacy of the practice is calculated by adding "Primary" and "Occasional" columns. In Table 2, we the four largest concentrations of categories of practice in Louisiana are *All Services/General Practice, Criminal Law, Family Law*, and *Personal Injury/Wrongful Death.*

Table 2: Practice Area Table

Practice Area	Primary	Occasional	Seldom	Never	Number Responding	Primacy 75% >	Primacy 50%-75%	Primacy < 50%
All Services/General Practice	32.9%	22.6%	18.8%	25.7%	319		x	
Aviation	0.3%	3.4%	7.5%	88.7%	292			x
Bankruptcy	5.5%	11.3%	17.2%	66.0%	309			x
Copyright	1.4%	4.1%	7.6%	86.9%	291			x
Business/Corporate	16.4%	23.5%	22.6%	37.5%	323			x
Criminal	44.5%	11.3%	11.5%	32.7%	355		x	
Eminent Domain	1.3%	4.4%	10.1%	84.2%	297			x
Employment/Labor Relations	4.4%	13.2%	22.1%	59.3%	317			x
Entertainmnt	0.3%	2.0%	10.2%	87.5%	295			x
Environmental/Pollution	3.0%	8.6%	10.6%	77.7%	301			x
Estate and Probate Law	13.2%	30.1%	18.1%	38.7%	326			x
Family Law	25.9%	24.1%	14.9%	35.1%	348		x	
Insurance	27.6%	19.9%	14.5%	38.0%	337			x
International Law	0.7%	2.0%	5.4%	91.9%	297			x
Legal Malpractice	1.3%	4.3%	11.6%	82.8%	303			x
Maritime	7.1%	11.3%	14.2%	67.4%	310			x
Medical Malpractice	10.3%	13.8%	21.6%	54.4%	320			x
Military	1.4%	1.4%	5.1%	92.2%	293			x
Personal Injury/Wrongful Death	41.3%	26.6%	10.2%	21.9%	361		x	
Real Estate	14.2%	16.5%	22.5%	46.8%	316			x
Social Security	3.7%	4.7%	15.6%	76.1%	301			x
Tax	1.4%	3.1%	4.8%	90.7%	291			x
Trade	0.0%	1.4%	3.7%	94.9%	272			x

2004 LSBA SURVEY: LAW FIRM SIZE

Reinforcing the suitability of small/micro-firm entrepreneurial research of law firms, the number of attorneys in firms illustrates that most attorneys are indeed in these small/micro firms. In these small or micro firms, as in other small or micro firms in other business areas, the person who makes decisions to change or adopt a technology is most likely going to be the same person who has to *use* the new technology. Of the 487 attorneys taking the survey, 433 responded to the question of firm size. The results are in Table 3 below:

Table 3: Number of attorneys in the law firm	
Number of Attorneys In Law Firm	Percentage
1	28.4%
2-5	30.5%
6-10	7.4%
11-15	6.2%
10-20	4.2%
21-30	8.8%
31-40	6.0%
41-50	2.1%
More than 50	6.5%

Over half, 58.9% of those answering the surveys were in firms of 1-5 attorneys. Law firms of 10 or fewer attorneys, clearly very small or micro organizations, represent the work environment of almost 2/3 (65.3%) of the respondents.

2004 LSBA SURVEY: TECHNOLOGY UTILIZATION DEMOGRAPHICS

Just to what extent attorneys use computers at work and at home illustrates the diffusion of technology in their personal and professional lives.

Responding to the question, "Do you use a computer in the workplace?" and to the question, "Do you use a computer at home?" the possible responses were Laptop, Desktop, None, Yes. Multiple responses were possible. If an attorney responded that they used both laptop and desktop computers in the workplace, the answer was placed into the database as "both". Out of 487 completed surveys, only two failed to answer these two questions. The percentages shown are of the 485 responses. The responses in Table 4 do not add up to 100% because multiple responses were possible.

Table 4: Computer use by attorneys at their workplaces and homes			
Workplace	Percentage	Home	Percentage
Both	24.7%	Both	18.8%
Desktop	52.8%	Desktop	51.8%
Laptop	10.9%	Laptop	12.8%
None	2.5%	None	11.3%
Yes	9.1%	Yes	5.4%

When asked about their internet access at home and at the office, the clear majority of attorneys seemed to be connected to the internet.. 481 out of 487 responded about their office internet access; while 456 out of 487 about their home internet access. Table 5 shows the percentages shown are of the responses:

Table 5: Internet access by attorneys at their homes and offices			
Office	Percentage	Home	Percentage
Yes	92.7%	Yes	91.7%
No	6.7%	No	8.3%
Don't Know	0.6%	Don't Know	0.0%

Attorneys were asked about the kind of internet access that they used. Of the 487 who completed the survey, 403 responded about internet service at the office, and 399 responded about their home service. The possible responses were DSL, Cable, Dial-up/Modem, and Don't Know. Table 6 shows the percentages from the responses.

Table 6: Internet access by attorneys			
Office	Percentage	Home	Percentage
DSL	60.5%	DSL	25.3%
Cable	23.1%	Cable	41.4%
Dial-up/Modem	11.9%	Dial-up/Modem	32.8%
Don't Know	4.5%	Don't Know	0.5%

2004 LSBA SURVEY: MEASUREMENT OF LEVELS OF SOPHISTICATION IN THE USE OF COMPUTERS AND APPLICATIONS – HOW DO YOU USE TECHNOLOGY?

The survey explored the degree of sophistication of computer usage by attorneys. This information shows the depth of working knowledge of computers in general, as well as the depth of its involvement in their personal and professional lives. If micro/small firms are run by attorneys who function as entrepreneurs within their fields, and if managerial decisions in those firms are largely instinctive, it is helpful to know what they are doing with various technologies. In order to measure diffusion of computer technology into attorney's homes and offices, it was necessary to learn for what purposes computers were being used both professionally and recreationally. Table 7 shows various computer uses, and asks if the use is primary, occasional, seldom or never. The total number of responses for each category out of 487 completed surveys is shown, along with the percentages are of those numbers who responded. Usage is calculated by adding "Primary" and "Occasional" columns.

Table 7 shows that attorneys are generally savvy in their use of technology for writing and research functions, but that the primary usages of a computer for them appears to be an evolution of the as an extension of the stalwart office typewriter. They also do basic chores like checking email and web surfing. It is interesting to see the degree that it is used legal research, as this marks for some a departure from conventional law books to electronic research. The secondary usages of computers to assist not only with office management but also with day-to-day living shows a comfort level with the technology. When management decisions are instinctive, managers decide about that which they know. It is clear that A significant number of attorneys are computer savvy.

2004 LSBA SURVEY: SOFTWARE IN USE BY ATTORNEYS

In order to explore the sophistication and complexity of software used by attorneys, the survey asked about the use of software used for word processing, image editing, anti-virus, etc. As software packages are not generally exclusive, respondents could select answers in several categories. Table 8 explores them:

Table 7: "What do you do with your computer at your home or office?"

Computer Use	Primary	Occasional	Seldom	Never	Number Responding	Usage 75% >	Usage 50%-75%	Usage < 50%
Legal Research	53.7%	37.6%	4.0%	4.7%	471	X		
Academic research	13.3%	30.3%	30.8%	25.7%	413			X
Word Processing/Typing	72.0%	15.1%	8.0%	4.9%	465	X		
E-Mail	70.3%	21.8%	4.3%	3.7%	464	X		
Web Surfing	34.1%	41.2%	17.4%	7.3%	449	X		
Scheduling/Appointmnts	34.4%	16.1%	18.3%	31.2%	442		X	
Bookeeping/Taxes	41.9%	16.1%	17.3%	24.7%	446		X	
Investment management	9.1%	13.3%	22.6%	55.0%	429			X
Travel Planning/Buy Tickets	15.9%	38.5%	29.0%	16.6%	452		X	
Ebay/Online Auctions	6.4%	16.1%	26.4%	51.0%	435			X
Banking/Bill Paying	16.1%	28.7%	14.9%	40.3%	442			X
CLE [Continuing Legal Education]	2.8%	13.7%	20.4%	63.2%	432			X
Connect to PDA	9.1%	9.1%	6.9%	74.9%	418			X
Download Music	3.0%	10.7%	15.6%	70.6%	429			X
Shopping	5.1%	33.6%	31.3%	30.0%	434			X
Online Education	1.6%	12.7%	24.5%	61.2%	425			X
Maps/directions	15.0%	51.4%	23.2%	10.5%	440		X	
Chatrooms/Message Boards	3.3%	9.4%	16.7%	70.7%	426			X
News/Sports/Weather	17.9%	44.1%	23.8%	14.2%	429		X	

Table 8: Over-the-Counter Software Use					
Software	Yes	Percent	Usage 75% >	Usage 50%-75%	Usage <49%
MS Office	199	40.9			x
MS Word	271	55.6		x	
MS Excel	97	19.9			x
MS PowerPoint	97	19.9			x
MS Internet Explorer	249	51.1		x	
Netscape Navigator	54	11.1			x
Word Perfect	319	65.5		x	
Corel Draw	18	3.7			x
Corel Presenter	15	3.1			x
Adobe Illustrator	94	19.3			x
Adobe Photoshop	56	11.5			x
Norton Personal Firewall	33	6.8			x
Other Photo Editing Software	65	13.3			x
Fax Software	62	12.7			x
Norton Antivirus	210	43.1			x
Norton Internet Security	126	25.9			x
Norton System Works	54	11.1			x
Spybot	52	10.7			x
Quicken	109	22.4			x

It is interesting to note that despite the emergence of and advocacy for the use of presentation software, there is use, but not widespread use of presentation software by attorneys. There is even less use of software used to configure photos and illustrations that are used in those presentations.

2004 LSBA SURVEY: COMMUNICATION DEVICES

A look at communications technology used by attorneys illustrates the degree of sophistication that they are willing to use in their work. Attorneys were asked simple yes or no questions. Provided below in Table 9 is the name of the communications technology, the number of attorneys who replied that they used the technology, and the percent of those who answered the question with a "yes.".

The survey showed that the most significant communication technology was the cell phone. The older technology; the pager, was used relatively little: about the same as the use of Palm PDA phones! This showed a strong adherence to practicality in this technology decision.

Table 9 Communications technologies		
Technology	Number Responding Yes	Percentage
Cellular Phone	448	92.0%
Pager	61	12.5%
Palm PDA	65	13.3%
Pocket PC	9	1.8%
Blackberry	19	3.9%
Integrated Palm /keyboard/phone	8	1.6%
Other communications device	12	2.5%

2004 LSBA SURVEY: LAW PRACTICE SOFTWARE

Professional practice-management software is often used by people who bill by the hour. Doctors, engineers and other professionals have begun to use software to manage their appointments and billing. Table 10 shows that other than a couple of clusters of attorneys using particular software packages, there is not a trend toward a single system for computerized office management:

Table 10: Timekeeping software		
Technology	Number Responding Yes	Percentage
ACT	4	0.8
Advanced Relations	0	0
Amicus Attorney	16	3.3
Kemps	0	0
Legal Files	3	0.6
Management Assist	1	0.2
Omega	6	1.2
PC Law	21	4.3
Practice Manager	2	0.4
Time v. 2.02	1	0.2
Time Matters/Billing Matters	17	3.5
Timeslips	66	13.6
Timetrax	0	0
Wamsutta	0	0
Other	55	11.3

2004 LSBA SURVEY: IMAGING DEVICES IN USE BY ATTORNEYS

The level of sophistication of the cameras, scanners and other imaging devices used by attorneys is another indication of the degree of their technology saturation. Table 11 below, lists the devices, the number of 'yes"" answers and the percentage of attorneys who use them. As multiple answers were possible, the total exceeds 100%.

Table 11 Imaging Devices

Technology	Number Responding Yes	Percentage
Video Camera	192	39.4
Digital Camera	254	52.2
Film Camera	200	41.1
Image Scanner	141	29
Computer Projector	32	6.6
Overhead Projector	34	7
Other camera or projection device	2	0.4

2004 LSBA SURVEY: TRIAL SOFTWARE IN USE

Given the emergence in some courts of electronic filings and electronic case management, firms are offering legal-profession-specific trial management software packages Table 12 below lists the software, the number of responses to the affirmative and the percentage.

Table 12 Trial Software

Technology	Number Responding Yes	Percentage
Director Suite	0	0.0%
Sanction	2	0.4%
Summation	21	4.3%
Trial Book	0	0.0%
Trial Pro	3	0.6%
Visionary	0	0.0%
Other trial software	12	2.5%

This question also asked intent questions for trial software:

Table 12 Trial Software Continued		
Technology	Number Responding Yes	Percentage
Don't use trial software and will not use it.	33	6.8%
Have not used trial software but may in future	268	55%

The results show that few attorneys use this software now, but over half (55%) indicate that they may in the future.

2004 LSBA SURVEY: INTENT TO USE COMPUTER SLIDE SHOW PRESENTATION SOFTWARE

Literature in the legal profession that advocates the use of MS PowerPoint and other computer slide show presentation software. As a measurement of future intent, we saw that despite the responses in Table 8, that fewer than 20% of attorneys presently use MS PowerPoint, when asked about their intent to use this software technology in the future was relatively high. Table 13 queries attorneys about their willingness to use the technology in mediation, in a bench trial (a trial before a judge with no jury), and in a jury trial:

Table 13: Intent

	Research Instrument Question 14, measuring intent.		
	RTU[1] Which of the following most closely describes your willingness to use CSSP Software in Mediation?	RTU[2] Which of the following most closely describes your willingness to use CSSP Software in Bench Trials?	RTU[3} Which of the following most closely describes your willingness to use CSSP Software in Jury Trials?
No. of responses	423	449	451
Very Willing added to *Somewhat Willing*	50.4%	69.7%	78.2%

These findings show a strong interest in this topic given the high number of responses in this category. Nearly 80% of attorneys indicated a willingness to use presentation software in a jury trial

2004 LSBA SURVEY: PRESENTATION SOFTWARE

As a continuation of the exploration of factors influencing to the intent to use presentation software, attorneys were asked which presentation software that they either used or would use. This question was asked to determine of any inconsistencies that might occur with their prior reply regarding MS PowerPoint. The response indicates that there is consistency in the survey results. Table 14 shows the name of the software, the number of attorneys who checked "yes" indicating willingness to use, and the percentage.

Table 14 Presentation Software

Technology	Number Responding Yes	Percentage
PowerPoint	226	46.4%
Corel Presentations	30	06.2%
Harvard Presentations	4	0.8%
Apple Keynote	5	1.0%
Other slideshow software	37	7.6%

2004 LSBA SURVEY: DEMONSTRATIVE EVIDENCE

Demonstrative evidence is used in time to represent something. It can be a model, photos, movies, simulations, videotapes, diagrams, maps, etc. To be used, it must acurately and fairly represent the object or situation at a particular time. Table 15 shows the responses of attorneys regarding their use of demonstrative evidence, and asks if its use is primary, occasional, seldom or never. The total number of responses out of 487 completed surveys in each category is given; the percentages are of those number responding is given. Usage is calculated by adding "Primary" and "Occasional" columns. This query again included the use of MS PowerPoint.

Table 15 Demonstrative Evidence

Demonstrative Evidence	Primary	Occasional	Seldom	Never	Number Responding	Usage 75% >	Usage 50%-75%	Usage < 50%
Anatomical Models	11.0%	31.7%	23.3%	34.0%	429			x
Structural/Architectural Models	5.2%	18.9%	25.8%	50.1%	407			x
Accident Reconstruction Models	7.9%	26.3%	24.6%	41.1%	418			x
Accident Reconstruction Diagrams	13.2%	33.3%	20.9%	32.6%	417			x
Enlarged Documents	39.1%	38.8%	8.9%	13.2%	448	x		
Enlarged Photographs	40.9%	37.8%	7.8%	13.4%	447	x		
Enlarged Maps	25.7%	37.3%	16.4%	20.6%	432		x	
Computer Animations	2.6%	11.7%	17.9%	67.8%	419			x
PowerPoint Utilization	7.0%	17.6%	21.1%	54.3%	427			x
Video Reenactments	2.2%	9.4%	16.7%	71.7%	413			x
Conventional slides w/ projector	4.8%	14.0%	19.9%	61.3%	413			x
Flip charts with Felt Markers	11.3%	32.7%	17.9%	38.1%	425			x
Smartboard	2.7%	7.9%	11.3%	78.1%	407			x

Table 15 clearly shows that despite an interest in presentation technology, the clear majority of attorneys rely upon technology that would have been found in a courtroom in the 1930's: enlarged documents, enlarged photos and enlarged maps.

CONCLUSION

Attorneys who use computers at home, and as more than a replacement for the office typewriter, are more likely to use technology in their law practices. Attorneys must believe in the usefulness and reliability of a technology before they are willing to adopt it. These findings fit with the instinctive management style of micro/small firm entrepreneurs. The majority of Louisiana attorneys are interested in using computer presentations in their mediation and trial work but at some time in the future. Finally, the majority of attorneys are in very small firms and use what they know, rather than risking time and effort on that which they do not, reinforcing the influence of perception and instinct in their decisions.

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ENTREPRENEURIAL OPPORTUNITY EXPLOITATION AND THE FAMILY: RELATIONSHIP-BASED FACTORS THAT AFFECT THE ADULT CHILD'S DECISION TO JOINTLY PARTICIPATE WITH PARENTS IN A NEW VENTURE

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ABSTRACT

Prior researchers have identified several predictors of an adult child's decision to join with parents in an existing family business. However, these studies have not investigated this decision with respect to a new venture. This study assesses the significance that involvement of a particular parent and the relative hierarchical roles of the child and the parents have on the likelihood that the adult child will join the new venture. This assessment compared the goodness-of-fit of models reflecting these factors using confirmatory factor analysis. The study supports the hypothesis that the adult child will be more likely to join a new venture in an exchange relationship as a co-owner with parents than as a subordinate to them in a role that reflects a continuation of an earlier attachment relationship. This finding provides important insights into factors that family members and their advisors should consider in planning for a new venture involving adult children and their parents.

INTRODUCTION

Family businesses are vital societal institutions. Their importance stems from their position as a common entity for conducting commercial transactions and their role as a cohesive force for the intergenerational family that offers possibilities for family members to invest in the business and participate in variety of business roles (Carland, Hoy, Boulton & Carland, 1984). The objective of this study is to evaluate the extent that the nature of a specific relationship with a parent or the prospective hierarchical positions of the child and parent(s) influence the decision of the adult child to enter a new family business. The focus on the decision to enter a new family business, should an opportunity to form such a business presents itself to the family, is distinct from either a decision to join an existing family business, or the decision to remain as a member of an existing family business because the roles in the new venture have not been previously defined. It is this distinction, emphasizing the interaction of opportunity exploitation and definition of the roles individuals play in that exploitation (Shane & Venkataraman, 2000), that places this study in the research domain of entrepreneurship.

Prior studies, e.g. Birley (1991) and Stavrou and Swiercz (1998), have focused on the adult child's decision to join an existing family business. The Birley study (1991) identified factors such as pressure from parents, interest in managing the business, certain industry characteristics and demographic factors as predictors of the adult child's decision to join the existing family business. The Stavrou and Swiercz (1998) model identified certain family factors, business factors, personal factors and market factors as alternative predictors of that decision. Neither study explored whether this decision may be affected by the strengths of relationships identified in the developmental psychology literature as characteristic of parents and children.

Gaining a better understanding of family businesses formation issues is important because these businesses represent a significant portion of the commercial activity in the United States. Family-owned businesses constitute an estimated 80-90% of all businesses. Approximately one-third of the Fortune 500 companies have significant family ownership. Family businesses employ about half of all employees in the United States, and these businesses account for 40% of the gross national product (Rodriguez, Hildreth & Mancuso, 1999; Kaslow, 1993; Kets de Vries, 1993; McClendon & Kadis, 1991; Rosenblatt, et al., 1985). Research relating to the decision-making surrounding family business formation is justified because the decision is important not only for the parents and the adult child but also, on an aggregate basis, for society as a whole. If adult children are unwilling to join with their parents to exploit an opportunity when it arises, the opportunity may be lost because neither party may individually be able to exploit it. As a result, society loses the beneficial effects of such a new entity in the marketplace.

THEORETICAL BACKGROUND AND HYPOTHESES

A child's development involves a process of socialization. Socialization can be defined as the process by which an individual comes to conform to societal demands (Solomon, 2000). Interpersonal relationships involved in socialization tend to fall into one of four general categories: Attachment, hierarchical, social identity, and reciprocal (Bugental & Goodnow, 1998). Attachment relationships can be described in evolutionary terms primarily as relationships initiated with the purpose of providing protection to very young children (Bretherton, 1992). The process evolves through successfully establishing social exchanges that result in reciprocity in levels of positive affect (De Wolff & van IJzendoorn, 1997). Once this attachment is formed, it provides a "secure base" that serves the function of reducing risk in dealing with novel or risky situations (Waters & Cummings, 2000). While primarily used in describing the early life stage relationship between the infant and the mother, the theory has been applied to later life stages. For example, attachment theory has been investigated with respect to middle-aged siblings and their elderly parents (Cicirelli, 1989). Although the direct effects of attachment relationships during early childhood have on later adult behavior has not been conclusively demonstrated (Waters & Cummings, 2000), indirect effects through influences on the 'internal working model' of the child that can have manifestations in later life behavior have been proposed (Thompson, 2000). 'Internal working models' conceptualized by Bowlby (1969) are a person's ability to model their interactions with their environment for the purpose of predicting outcomes (Bretherton, 1992). For example, a child that has an 'internal working model' that involves a lifetime pattern of consulting with his or her parents in times of uncertainty would be expected to continue to do so into adulthood.

Hierarchical relationships involve differences in relative ranking due to many imbalances, such as those related to power or authority. Contingency theorists, generalizing their theories to all organizations, note that small organizations (such as a family) do well with a centralized structure and top-down decision making as opposed to larger organizations that require a more decentralized decision structure (Donaldson, 1997). Hierarchical relationships can be based either on the formal structure of the organization or based on attributes such as possession of a particular expertise (Hardy & Clegg, 1997). Typically, in the family hierarchy, parents occupy a superior hierarchical position with respect to their adult children that is a continuation of their earlier roles.

Social identity relationships are reciprocal and benefit the parties involved by linking persons that are socially similar in significant ways (Tajfel, 1982). Functionally, these relationships provide protection and esteem to in-group members and facilitation of group-level activities (Bugental & Goodnow, 1998). Examples of social identity relationships include the peer group relationship types of cliques and gangs. These relationships are typically developed outside the family as part of a search for an individual's autonomy from the family. The strength of relationships with parents may diminish as a result. These relationships can become significant in a family business context as their influence on the adolescent or young adult come at a life stage when they may be at an entry point for assuming a significant role in the family business.

Reciprocal relationships can be conceptualized as a negotiated relationship between functional equals that includes not only tangible exchanges of resources, but also intangible exchanges of mutual affect and pledges of future mutual support as well (Bugental and Goodnow, 1998). While friendships can be categorized as reciprocal in both tangible and intangible terms, relationships such as adult-child relationships can also involve tangible and intangible exchanges as well (Kaufman & Uhlenberg, 1998). These reciprocal relationships between adult children and their parents can emerge or strengthen as the social identity relationships wane when the adolescent enters adulthood.

Hinde and Stevenson-Hinde (1987) stress the importance that sociocultural schemes of reference, stemming both from current relationships and from past experiences from prior relationships, have on shaping the context that affects the individual's current behavior. This view of cognitive process recognizes a component that is synchronic, based on existing mental structures, and diachronic, evolving over prior periods (Magnusson & Stattin, 1998). From the synchronic perspective, the current context of the individual within a social system, acting through current developmental structures and relationships will determine the behavior of the individual toward the system. From the diachronic perspective, the past contexts will also affect the behavior of the individual through the process of developing the current set of developmental structures and relationships. Therefore, the attitudes of adult family members toward their parents are based on the nature of both past and present relationships with them.

Magnusson and Stattin (1998) conceptualize that the family is a system where each family member interacts with the others to form both an overall family context and a context from the point of view of each family member. The fact that individual family members can generate different individual contexts from the same overall family context is partially attributable to individual biological differences (Plomin, 1989). However, part of the differences can also be attributed to differences among family members in the strength of the attachment, hierarchical, and reciprocal relationships within the family and the social identity relationships outside the family. The development of these relationships can be viewed with a "life course paradigm" in which the major dimensions are:

> (i.) the timing of life transitions in the context of historical change, (ii.) the synchronization of individual life transitions with collective familial ones and their impact on generational relations, and (iii.) the impact of earlier life events, as shaped by historical circumstances previously encountered, on subsequent events (Hareven, 1994, p. 439).

Thus, the history of these relationships between the child and the parent is conceptualized to be a significant influence on their current strength (Silverstein & Bengtson, 1997).

Various theoretical models of family systems utilize these relationships in some form as a framework. Some models focus on the attachment and reciprocal relationships as represented by cohesion, adaptability and communication as determinants of nature of the family relationship (e.g. Olson et al., 1983; Olson et al., 1979). Other models emphasize the hierarchical relationships within the family represented by the family member roles of dominance or submission (e.g. Bugental et al., 1997). In contrast, social identity relationships are motivated by the search for autonomy, which develops in adolescence, which tend to diminish the strength of the other types of relationships (Frank et al., 1988).

The present study assesses which of three possibilities is the most predictive of whether an adult child chooses to join with his or her parents in starting a new venture. The first possibility assessed is that the decision to join with parents would be significantly dependent upon a combination of the strength of underlying attachment, reciprocal and hierarchical relationships and whether the father, mother or both parents were involved. The second possibility assessed is that the decision would be dependent only upon whether the father, mother or both parents were involved, but not the strength of attachment, reciprocal and hierarchical relationships between the adult child and parents. The third possibility that was assessed was that the decision would be dependent only upon the strength of attachment, reciprocal and hierarchical relationships between the adult child and parents, but not on whether the father, mother or both parents were involved.

The attachment relationship of the adult child to his or her parents in the new business formation context would be expected to be consistent with an "internal working model" (Thompson, 2000) of the child that involves a history of consultation to aid in dealing with the risk and uncertainty in many contexts. Risk and uncertainty are certainly characteristic of new ventures. Thus, the adult child that has a strong attachment relationship with his or her parents could be expected to seek to employ them in the venture even if their economic contribution to the business may be less than that of an unrelated employee because their presence would reduce the anxiety of the adult child.

The reciprocal relationship between the adult child and his or her parents in the business formation context is conceptualized to be one that seeks to maximize camaraderie, involving mutual support and positive affect (Bugental & Goodnow, 1998), between the parties. An example of behavior stemming from such a relationship would be one of seeking a partnership between the adult child and one or both parents in the new family business. As members of the business that are equal in rank, the relationship would tend to maximize both the reciprocity and camaraderie between them.

The hierarchical relationship in the business formation context is conceptualized to be one of obedience of the child to the requests of the parents. An example of behavior stemming from this kind of relationship would be the child accepting an invitation from the parents to join a new family business with one or both parents when asked even if the adult child would be in the role of a subordinate.

Thus, the alternative hypotheses reflect the significance of the specific relationships with either or both parents, the hierarchical position of the parties reflecting the attachment, reciprocal and hierarchical relationships between the adult child and parents or the combination of both factors on the adult child's intention to join a new venture with his or her parents:

H1: The adult child's intention to join the family business will be affected by the two parties' relative hierarchical position in the new venture and by the specific parent that would be involved.

H2: The adult child's intention to join the family business will be affected by which parent would be involved in the new venture, but not by the hierarchical relationship of the parties.

H3: The adult child's intention to join the family business will be affected by the hierarchical relationship of the parties, but not by the specific parent that would be involved.

METHOD

The sample for this study consisted of 136 undergraduate student respondents at a Southeastern United States public university. Survey respondents voluntarily completed the instrument; no consideration was offered in exchange for their cooperation. Written instructions were provided with the survey instrument. Respondents were given as much time as they required to complete the instrument. No verbal instructions were given once the instruments were distributed.

Of the 136 total responses, only 75 respondents whose biological parents were still together and whose surveys were returned completed were used in the analysis. The decision to exclude respondents whose biological parents had divorced or separated, or who had a deceased biological parent was made to preclude any effects that good or bad relationships with stepparents might have on the types of relationships of interest in the present study. In this subset of usable responses, a total of 37 participants were males and 38 were females. Eighteen participants were under 22 years, thirty-one were 22-24 years of age, twenty-one were 25-30 years old, four were 31-35 years old and one was over 41 years old. Taken as a whole, this demographic information indicates that the sample is typical of the life stage in which the adult child typically would be deciding whether to join a family business.

This study assessed the alternative hypotheses reflecting the effects of relationships with a specific parent and/or the attachment, reciprocal and hierarchical relationships between the adult child and parents on the adult child's intention to join a new venture with his or her parents. Thus, initial models based on all three alternative hypotheses were tested. A fourth model reflecting a respecification of the model representing H3 that eliminated the three items reflecting the parents jointly and individually inviting the child to join as co-owner was also assessed.

To accomplish this testing, items were generated that reflect the various combinations of both parents and mother and father individually, relative hierarchical position (i.e. superior, partner or subordinate), and roles of invitee versus inviter. The instrument required a response as to the likelihood that the adult child would become involved in a new business venture, given the possible combinations of these factors. The responses to these items reflecting that they would join the new venture were made on five-point Likert-type scales with "very likely", "likely", "as likely as not likely", "unlikely", and "very unlikely" as the possible responses. A summary of the overall research model and alternative indicator loadings allowed on the four alternative relationship models are shown in Table 1.

Table 1: Factor Loadings for Alternative Models								
Item	Inviter	Invitee	Parent's Position	Child's Position	Model 1	Model 2	Model 3	Model 4
1	Parents	Child	Superior	Subordinate	ξ_{All}	$\xi_{Parents}$	$\xi_{Hierarchical}$	$\xi_{Hierarchical}$
2	Father	Child	Superior	Subordinate	ξ_{All}	ξ_{Father}	$\xi_{Hierarchical}$	$\xi_{Hierarchical}$
3	Mother	Child	Superior	Subordinate	ξ_{All}	ξ_{Mother}	$\xi_{Hierarchical}$	$\xi_{Hierarchical}$
4	Parents	Child	Co-owner	Co-owner	ξ_{All}	$\xi_{Parents}$	$\xi_{Reciprocal}$	------
5	Father	Child	Co-owner	Co-owner	ξ_{All}	ξ_{Father}	$\xi_{Reciprocal}$	------
6	Mother	Child	Co-owner	Co-owner	ξ_{All}	ξ_{Mother}	$\xi_{Reciprocal}$	------
7	Child	Parents	Co-owner	Co-owner	ξ_{All}	$\xi_{Parents}$	$\xi_{Reciprocal}$	$\xi_{Reciprocal}$
8	Child	Father	Co-owner	Co-owner	ξ_{All}	ξ_{Father}	$\xi_{Reciprocal}$	$\xi_{Reciprocal}$
9	Child	Mother	Co-owner	Co-owner	ξ_{All}	ξ_{Mother}	$\xi_{Reciprocal}$	$\xi_{Reciprocal}$
10	Child	Parents	Subordinate	Superior	ξ_{All}	$\xi_{Parents}$	$\xi_{Attachment}$	$\xi_{Attachment}$
11	Child	Father	Subordinate	Superior	ξ_{All}	ξ_{Father}	$\xi_{Attachment}$	$\xi_{Attachment}$
12	Child	Mother	Subordinate	Superior	ξ_{All}	ξ_{Mother}	$\xi_{Attachment}$	$\xi_{Attachment}$

The instrument resulted from a developmental process designed to enhance construct validity (Gerbing & Anderson, 1988; Anderson & Gerbing, 1988; Hinkin, 1998; Koufteros, 1999). The initial instrument development step was a review of the family business, organizational theory and developmental psychology literatures, interviews with three family business owners, and expert consultation with University psychology and business faculty. Next, the draft instrument was presented to two University faculty members for a construct validity review. In the third step, exploratory factor analysis was performed separately for each construct to "purify" the measure by deleting items that loaded heavily on more than one factor or contained less than a .5 corrected item-total correlation (Song & Montoya-Weiss, 2001). All twelve items were retained. Because the number of respondents was not adequate to simultaneous test all factors simultaneously, each factor was analyzed sequentially. Scale reliability for each subscale, as expressed by Cronbach's Alpha, was then calculated. In the next step, a confirmatory factor analysis is then run on a measurement model and, in the present study, on each alternative model, to assess relative model fit and unidimensionality.

RESULTS

Table 2 reports the descriptive statistics including the means, standard deviations and bivariate correlations for all variables. High levels of inter-item correlation were noted, all items had correlations that were significant at the $p<.01$ level. Possible gender differences were examined. The mean responses relating to acceptance of an invitation to join the mother as a subordinate in a new venture indicated that males are more likely than females to accept (p=.051). No other significant gender differences were noted.

The effect of actual family business working experience was also assessed. The results have to be considered in light of the small numbers of respondents who are in this category. Only five respondents reported working in their father's business and only three reported working in their mother's business, although thirty-four of the seventy-five respondent's fathers had businesses and eleven of the respondent's mothers had businesses. However, based on this very small sample of current parental business participants, no significant differences at the $p<.10$ level were noted.

An exploratory factor analysis of each relationship construct resulted in each having only one factor with an Eigenvalue in excess of 1.0 and no corrected-item total correlations less than 0.50. Construct reliabilities based on Model 4 ranged was .94 for Hierarchical (Items 1, 2 & 3), .93 for Reciprocal (Items 7, 8 & 9) and .89 for Attachment (Items 10, 11 & 12). Discriminant validity was assessed for the constructs using three tests (Koufteros, 1999). The first test measures the incremental $\chi2^{change}$ where the relationship strengths between the latent variables are sequentially fixed at one and the $\chi2$ change for the additional degree of freedom is evaluated as to significance. The second test compares the average variance explained (AVE) within the construct to the variance explained between the constructs. The third test determines if 1 (complete correlation) is within the confidence interval for the correlation between the constructs, calculated as the correlation plus or minus two times the standard error of the correlation. The model displayed satisfactory discriminant validity under all three tests.

An assessment of the fit of various model specifications is shown in Table 3. The first model, serving as a baseline and reflecting the effects of relationships with a specific parent and/or the attachment, reciprocal and hierarchical relationships between the adult child and parents on the adult child's intention to join a new venture with his or her parents did not result in a good fit with the data. The second model gave primacy to the family relationships involved without considering the context under which the parties would be extending an invitation or the relative positions of the parties in the new venture. Thus, all items in the three contexts of relating to both parents were constrained to load together, as were the items for the father and the items for the mother. This hypothesis provided no substantial improvement in model fit over the baseline model. The third model, based on the hypothesis that the adult child would be basing the decision to join the parents on either the hierarchical relationship with the parents, the amount of camaraderie involved and the benevolence shown to the parents, resulted in an increase in model fit over the prior two models. The fourth model, substantially similar to the third model, was specified after data collection as a result of noting that the condition of the child accepting an invitation to join as a co-owner and co-manager correlated highly with the condition of the child accepting an invitation to join as a subordinate, rather than the condition of the child extending the invitation to join as co-owner and co-manager. The items relating to the latter condition therefore was judged to be redundant. The fit of this final model reached satisfactory fit levels even though the sample size was modest.

The absolute fit of the fourth model as, measured by the $\chi 2$ statistic, was 66.19. Other measures of absolute fit employed to evaluate the model included the Goodness-of-Fix Index (GFI) (Jöreskog & Sörbom, 2001; Tanaka & Huba, 1984) which was .84 and the Root Mean Square Residual (RMSR) (Jöreskog & Sörbom, 2001) which was .06. Neither measure has an absolute threshold for acceptability (Hair et al., 1998). The incremental fit of the model was evaluated using the Normed Fit Index (NFI) (Bentler & Bonnett, 1980) and the Comparative Fit Index (CFI) (Bentler, 1990). This model resulted in a score of .90 for a NFI and a score of .93 for a CFI. A threshold of .90 is recommended for these measures (Bryne, 1998), which was achieved by this model.

Table 2: Descriptive Statistics

VAR	PICS	FICS	MICS	PICP	FICP	MICP	CIPP	CIFP	CIMP	CIPS	CIFS	CIMS
PICS												
FICS	.91											
MICS	.81	.74										
PICP	.81	.77	.67									
FICP	.73	.82	.56	.90								
MICP	.63	.56	.76	.76	.67							
CIPP	.56	.55	.46	.49	.49	.27						
CIFP	.54	.61	.38	.47	.59	.26	.83					
CIMP	.46	.44	.43	.43	.45	.40	.79	.80				
CIPS	.39	.33	.38	.39	.32	.32	.61	.52	.53			
CIFS	.36	.39	.36	.40	.42	.25	.53	.59	.48	.75		
CIMS	.37	.34	.38	.40	.35	.39	.44	.46	.49	.74	.82	
Mean	2.04	2.09	2.00	1.85	1.95	1.89	2.65	2.53	2.75	3.01	2.60	2.79
S. D.	1.25	1.24	1.19	1.11	1.13	1.05	1.32	1.30	1.16	1.30	1.32	1.21

PICS = Parents Invite Child as Subordinate
FICS = Father Invites Child as Subordinate
MICS = Mother Invites Child as Subordinate
PICP = Parents Invite Child as Peer (Co-owner)
FICP = Father Invites Child as Peer (Co-owner)
MICP = Mother Invites Child as Peer (Co-owner)
CIPP = Child Invites Parents as Peers (Co-owner)
CIFP = Child Invites Father as Peer (Co-owner)
CIMP = Child Invites Mothers as Peer (Co-owner)
CIPS = Child Invites Parents as Subordinates
CIFS = Child Invites Father as Subordinate
CIMS = Child Invites Mother as Subordinate

The parsimonious fit of this model was evaluated using the Adjusted Goodness of Fit Index (AGFI) (Jöreskog & Sörbom, 2001), the Normed $\chi 2$ (Jöreskog & Sörbom, 2001), and the Non-normed Fit Index (NNFI) (Bentler & Bonnett, 1980). The model resulted in scores of .71 for the AGFI, 2.76 for the Normed $\chi 2$ and .90 for the NNFI. While Hair et al. (1998) suggest that the minimum acceptable value for AGFI is .90, Bryne (1998) argues that fit measures that consider parsimony often have acceptable levels that are lower than measures independent of the consideration of parsimony, with parsimonious fit indices in the range of .50 possible for models that measure .90 on non-parsimonious fit indices. Hair et al. (1998) suggest that the Normed $\chi 2$ should exceed 2.00 and that the NNFI should be at least .90. The model scores were therefore acceptable on the Normed $\chi 2$ and NNFI and marginal on the AGFI. In sum, the evidence suggests that the model is a reasonable representation of the data.

In assessing whether the three relationship types represented a higher order factor, the structural model achieved the essentially the same fit statistics as the final measurement model, Model 4. In specifying the structural model, the higher order factor loading was specified to be 1.00 with respect to the reciprocity relationship to address an offending estimate in excess of 1.00 for the relationship. With this modification, the model achieved a $\chi 2$ of 66.92 with 25 degrees of freedom, a GFI of .84, an RMSR of .10, a NFI of .90, a CFI of .93, an AGFI of .72, a normed $\chi 2$ of 2.68 and a NNFI of .90. The higher order construct explained substantially all of the variance in reciprocity as a result of the constraint imposed explained approximately half of the variance in the other two latent variables. Explanation of a significant portion of the variance of first-order factors is required for second-order factor recognition (Carless, 2001). As such, the data makes a plausible, although not conclusive, case for the existence of this higher order factor.

DISCUSSION AND LIMITATIONS

Because of the preponderance of family businesses and their vital contribution to the economy, the circumstances surrounding milestone events in the family business are significant. The adult child's decision as to whether or not to join his or her parents to start the business is certainly one of the milestone events. The primary objective of this study was to evaluate the relative effects that involvement of specific parents in the new venture and the relative hierarchical positions of the adult child and the parents in that venture have on this decision. This objective was accomplished through scale refinement procedures that initially utilized exploratory factor analysis (Hinkin, 1998) and a review of the corrected total item correlations (Koufteros et al., 2001) to develop and refine the scales. Confirmatory factor analysis was then used to evaluate the dimensionality of the criterion (e.g. Marsh & Hovcevar, 1988) by comparing the fit of four competing models of its dimensionality.

Table 3: Model Fit Assessments				
Model	1	2	3	4
Absolute Fit				
χ^2	547.57	521.60	379.31	66.19
Degrees of Freedom	54	51	51	24
Goodness of Fit Index (GFI)	.48	.48	.57	.84
Root Mean Square Residual (RMSR)	.26	.28	.22	.06
Incremental Fit				
Normed Fit Index (NFI)	.50	.52	.65	.90
Comparative Fit Index (CFI)	.52	.54	.68	.93
Parsimonious Fit				
Adjusted Goodness of Fit (AGFI)	0.24	0.2	0.34	.71
Normed χ^2	10.14	10.22	7.43	2.76
Non-normed Fit Index (NNFI)	.41	.41	0.59	0.9

Model 1: All relationships and contexts
Model 2: Each relationship (i.e. Parents, Father, and Mother) measured separately.
Model 3: Each hierarchy position (child enters as subordinate, both child and parent enter as equals as a result of each inviting the other and parents enter as subordinates).
Model 4: Model 3 respecified to delete parents inviting child to join as equal but retaining child inviting parents to join as equals.

The first finding of the study was evidence to support the hypothesis that the decision of an adult child to join a new family business with his or her parents will depend on the relative roles of the parties in the new venture, but not which parent was involved (Hypothesis 3). The respondents in this study showed a clear preference for entering into a new venture as a co-owner. The second finding was evidence to support the hypothesis that this factor is more predictive than the specific family relationships involved (i.e. simply being the parents, father or mother) as predicted in Hypothesis 2. In other words, the role of the adult child in the new venture was a bigger factor in the decision to enter the business than the opportunity to be involved with a specific parent or both parents without consideration of relative hierarchical roles in the new venture. Finally, the model based on only the relative hierarchical roles of the parties in the new venture fit the data better than the model based on Hypothesis 1 which considered both these relative roles and the specific family relationships that were involved. The data also provides some support for the existence of a second-order factor based on a combination of Hierarchy, Reciprocity and Attachment. However, because of the modest amount of variance in Reciprocity and Attachment that is explained by the structural model, the existence of such a higher-order factor was not established conclusively. In sum, the data suggests that the adult child's decision whether or not a join with his or her parents in a new venture will primarily depend on whether the relative roles the child and parents will occupy in the management of the venture will be substantially equal.

The parent of an adult child may find that offering them a position as co-owner may prove difficult. The parent has commonly functioned in a superior role throughout the development of the child and may be reluctant to cede authority. In addition, the parent may wish to occupy a superior hierarchical role outside the business and find maintaining two different roles, authoritarian outside the business and egalitarian inside the business, difficult. Disparities in resources between the adult child and parents at time of founding may also be an impediment to an egalitarian relationship within the business. The parent will frequently be able to contribute more capital, experience and social capital to the venture and, as a result, expect a substantially higher initial ownership percentage. If the business will be required to obtain credit and loan guarantees are required, the parent will frequently be pledging more assets than the child. However, in spite of any negative effect on the parent caused by an unequal initial contribution of resources, the parent potentially gains security from binding the adult child to a long lasting relationship with the business. The adult child's participation potentially improves the chances of business survival in the case of severe illness of the parent, and provides a likely buyer of the parental interest upon their retirement. The participation of professional advisors may facilitate the consideration of these factors in planning for the new family venture.

Several limitations to the study should be noted. Since the sample was limited to students at a single university, the sample respondents may not be representative of adult children in other regions, countries, ethnic groups, or life stages. In addition, this study does not measure these factors for all possible combinations of extended families that occur in contemporary society. While the contextual factors provided evidence of satisfactory fit to the sample data, the possibility that additional contextual factors may also be descriptive of the decision to join with the parents in the family business. Alternative approaches to the research design were considered. An instrument could have been developed to sample children who are currently involved in a family business and compare the responses with those from children from the same family who chose not to participate in the business. However, since the criterion of interest relates to the adult child's attitudes prior to venture formation rather than attitudes after the venture has begun, this second approach lacked construct validity.

Seeking a better understanding of the adult child's decision to join with his or her parents in a new family business is a useful direction for future research. Assessing whether the model's explanatory power holds for the adult child's decision to join a new venture with various extended family combinations should be a short-term research objective as these various family combinations are now commonly encountered. The long-term objective, a satisfactory path model for the antecedents of the decision, will result from assessing various alternative predictors of the criterion. Many promising instruments, such as those utilizing family cohesion and adaptability in the context of a family system (e.g. Olson, 1993) already exist and offer a likely starting point in achieving that objective. In addition, research into the perspectives of other family members, such as the perspective of the father, mother and siblings is necessary to fully understand the dynamics of the initiation of a new family business ventures.

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BUSINESS PLAN DEVELOPMENT FOR SERVICE VENTURES: INTEGRATING CUSTOMER EXPERIENCE MANAGEMENT

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ABSTRACT

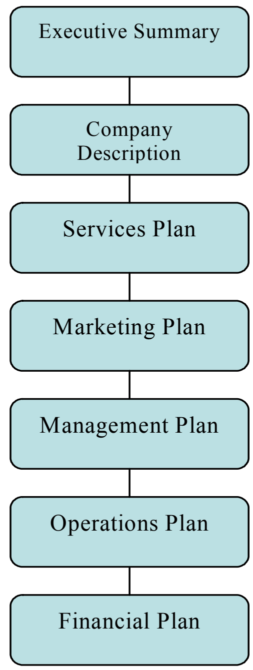
This paper introduces customer experience management to the traditional services plan model. It provides a framework entrepreneurs can use to develop plans that incorporates three types of clues that influence customers' thoughts, feelings and behaviors. These clues are: (1) functional – the technical performance of the service; (2) mechanic - tangibles associated with the service; and (3) humanic - the behavior and appearance of service providers. These clues play an important role in creating the customer's service experience, influencing both rational and emotional perceptions of service quality. By including these clues into the business plan for a services venture, entrepreneurs have a better opportunity of "getting off on the right foot", thus ensuring firm survival and prosperity.

INTRODUCTION

A business plan is a basic model and description of a new venture. It is used internally to provide parameters for the firm's owners and employees and to solidify its goals. It is also used externally to attract investors and other potential stakeholders such as customers. It should provide a clear picture of all the important aspects of the proposed venture. Because services ventures are different from goods ventures, however, the traditional business plan model is incomplete. A business plan for a service organization *should* provide a modelas well as a clear description of how the business intends to make an emotional connection with customers and systematically manage their experiences with the organization. However, traditional business plan outlines do not provide a section, nor do they integrate customer experience management throughout the different sections of the plan.

The basic business plan outline for a services venture has sections for: general company description, services plan, marketing plan, management plan, operations plan, and financial plan (see Figure 1).

Figure 1: Traditional Business Plan Model



The general company description outlines the primary products and/or services, current status of the start-up, name and location of the business, and legal formation. In the typical services section of the business plan, entrepreneurs are asked to provide a basic description of the service itself, any unique characteristics or special advantages, stage of development, applicable legal protection, potential liabilities, dangers relating to trends, style, or fashion, and comparisons to similar services offered by competitors.

The marketing section of the business plan identifies the target market. It is a demographic, psychographic, and geographic description of the target market, projects market share, outlines benefits provided to the customer, pinpoints competitors, establishes a competitive advantage, and then requires the entrepreneur to develop a marketing strategy. This strategy includes describing how you will identify and attract customers, outlining channels of distribution, discussing selling procedures, establishing pricing, credit and collection policies, and creating plans for sales promotions and advertising.

The management plan introduces the owner(s) and their qualifications. It also provides information on other key personnel, advisors, directors, investors, and other outside resource people along with their qualifications. Plans are also presented for recruiting, training, and compensating employees. The operations plan discusses methods of service delivery, quality control, and customer support at the most basic level including warranties, guarantees, and support strategies and obligations. It also includes a description of operating facilities such as location, layout, and equipment.

And the financial plan outlines start-up capital requirements. It presents projections of the company's financial statements over a period of five years. The forecasts include balance sheets, income statements, cash flow statements, and a break-even analysis. The plan also indicates how much capital is needed from prospective investors and the intended purpose for the money, and potential return on investment.

Intuitively, you might find strategies for customer experience management in the services plan, marketing plan, and/or operations plan. Entrepreneurs are really only addressing the functional or rational components of customer experience management at best. The focus is on the technical nature of the experience, such as reliability and quality. At no point in the traditional business plan model does the entrepreneur have the opportunity to make a plan to establish an emotional connection with potential customers. According to Berry and Carbone (2007), great organizations go beyond the functional aspects of the business to establish emotional connections with their customers. The business plan model we propose in this paper takes them beyond the commodity of the service offering, engaging customers at both the rational and emotional levels, thus increasing customer commitment to the business and creating a total customer experience.

LITERATURE REVIEW

Services are performances rather than objects – the customer doesn't have something to pick up and inspect prior to purchase, nor does he own a tangible asset after the exchange. Customers therefore look for clues that are available to them before and during the service performance that they can evaluate. Numerous clues of varying importance are embedded in these performances, and customers rely on them to choose services and evaluate service experiences. Customers form overall perceptions of experiences based on the technical performance of the service (functional clues), the tangibles associated with the service (mechanic clues), and the behavior and appearance of service providers (humanic clues). Functional, mechanic, and humanic clues play specific roles in creating the customer's service experience, influencing both rational and emotional perceptions of service quality. By definition, a good customer experience is good customer service; the experience is the service. As a result, consistent design and orchestration of these clues is a critical responsibility of the business owner.

The distinction among functional, mechanic, and humanic clues can be subtle. For example, a retail salesperson who answers a customer's question about when an out-of-stock item will be available is producing both functional and humanic clues. The accuracy of the information is a functional clue. The salesperson's choice of words and body language are humanic clues. One salesperson may answer the question disinterestedly, and another may answer enthusiastically. A customer’s emotional response to the differing humanic clues is likely to be quite different even if the information is accurate in both cases. Consequently, this same cusomer's overall impression of the service is likely to be different.

Conceptual Basis for Experience Clues

Clues create the service experience by influencing customers’ thoughts, feelings and behavior. The important influence of affect or feelings is well documented in behavioral sciences research. This research shows that affect or mood influences how people think and act (Poon, 2001). Research shows, for example, that positive mood seems to help people recall positive material from memory. This is because when people are in a particular feeling state, they try to maintain that state. Consequently, memories that are congruent with that feeling are more accessible and more likely to come to mind (Isen, 1987). This pattern does not hold for negative moods, however. It is thought that people try to improve a negative mood by avoiding recall of negative memories (Poon, 2001). Mood also influences people’s evaluations. For example, one study found that cartoons were rated as funnier by subjects who were smiling than subjects who were frowning (Laird, 1974).

Mood or affective states also influence the information processing strategy individuals are likely to adopt. People in a good mood are more likely to use quicker mental short-cuts in decision making whereas people in a sad mood are more likely to use a thorough decision-making strategy (Schwarz, 2000; Schwarz & Clore, 1996). Research shows that we use our moods as a source of information. Evaluative judgments involve people implicitly asking themselves, “How do I feel about this?” (Schwarz & Clore, 2003). Positive moods increase the likelihood of many positive behaviors. Positive moods seem to make someone more helpful and may also promote cooperative behavior in conflict resolution situations (Isen & Levin, 1972; George, 1998; Ford, 1995; Baron 1997). For example, a study of dyadic negotiations found that positive mood subjects were less likely to display hostility or break off negotiations and more likely to see the point of view of others and adopt a problem-solving approach to the negotiations (Carnevale & Isen, 1986). Customers’ moods may have particular impact on how they think and act in service encounters because of the interpersonal nature of these encounters (Gardner, 1985). Thus, it seems critical that firms seek to manage experience clues in ways that positively influence customers’ mood.

One opportunity to do this is with the tangible elements of the service experience – mechanic clues. Environmental psychology and marketing research confirms the influence of mechanic clues on customers. At its foundation, environmental psychology draws from the stimulus-organism-response (SOR) paradigm in psychology (Spangenberg, Crowley & Henderson, 1996). In an environmental psychology context, the physical environment or stimulus (S) (i.e., mechanic clues) causes an evaluation by a person or organism (O), which results in a response (R). Consequently, environmental psychologists have examined the physical environment’s influence on people’s thoughts, feelings, and behaviors, and they have found the three to be complex and interrelated. In a widely studied model, Mehrabian and Russell (1974) proposed that the three basic emotional states of pleasure, arousal and dominance or control mediate behavior in an environment. Pleasure refers to the degree to which a person feels good, happy, or satisfied in the situation; arousal refers to the degree to which a person feels excited or stimulated; and dominance refers to the extent to which the individual feels in control of the situation. These emotions are associated with behavioral responses, which are categorized as either approach or avoidance behaviors. Approach behaviors are positive behaviors directed at a particular place, such as a desire to stay, explore or affiliate. Avoidance behaviors reflect the opposite. Thus, the environment can trigger feelings that either encourage someone to stay in an environment or to leave it.

Research in marketing confirms the influence of the environment on customers. Donovan and Rossiter (1982), for example, tested the Mehrabian-Russell model in a retail setting and found that the pleasure and arousal dimensions of the model are strong predictors of in-store behavioral intentions, such as lingering in the store or purchase. In this study, pleasure was a determinant of desire to stay and explore in the store, while arousal was also found to increase customer time spent in the store as well as willingness to interact with sales associates. Researchers in marketing have also focused on the effects of specific ambient factors or clues, such as lighting, music, or scent. For example, in studies of the effects of music in retail and restaurant environments, Milliman (1986) found that slow music tempo encouraged restaurant customers to stay at their tables longer and spend more and also encouraged grocery shoppers to spend more.

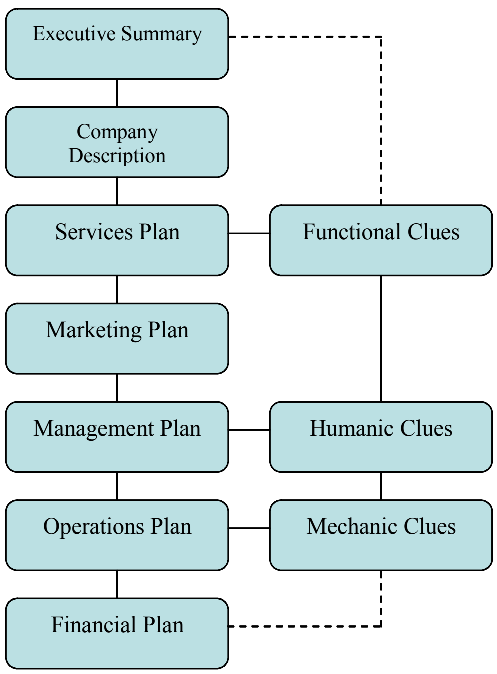
Clues Play Different Roles

Functional, mechanic, and humanic clues play specific roles in creating the customer's service experience. Functional clues primarily influence customers' cognitive or calculative perceptions of service quality. Mechanic and humanic clues primarily influence customers' emotional or affective perceptions. Thus technical competence in service performance is not enough if they aspire to build a reputation for superior service and build preference for their company. How the service is performed is important to customers, too, because it influences the emotional perceptions of quality. For example, a restaurant that provides a quality meal, but has slow table service and a shoddy environment is not likely to survive against competitors who deliver not only good food, but do so courteously and efficiently in a clean, quality environment

INTEGRATING CUSTOMER EXPERIENCE MANAGEMENT INTO A SERVICES BUSINESS PLAN

This section of the paper identifies how service clues fit into the business plan for a services venture. Entrepreneurs do not have to abandon the traditional business plan model. Instead, they can take a more comprehensive approach to initiate their ventures. The idea is to "get off on the right foot" and eliminate common problems before they have a chance to emerge in the business. The traditional business plan model is presented below (as previously discussed in the paper), with the addition of clue planning. The functional clue plan is integrated into the services plan, the humanic clues are addressed in the management plan, and the mechanic clues are included in the operations plan. See Figure 2 below:

Figure 2: Integrating Clue Plans into the Traditional Business Plan for Services Ventures



The next section of the paper provides an example of a small services start-up venture and how these clues can be included in the appropriate sections of the business plan.

CASE IN POINT

A small personal training studio called Body Evolution is utilizing this very approach for venture planning. Body Evolution is a personal training studio offering multidimensional programs to meet clients' fitness needs such as strength training, circuit training, plyometrics, sport-specific training, and functional training. They also offer complete nutritional programming and counseling based on clients' unique needs and lifestyles. The facility is 1,500 square feet and fully equipped for personal and group training classes. The owner of Body Evolution understands the importance of providing exceptional customer service at every level to attract and retain clients. She has identified all the key "clues" for each of the areas: functional, humanic and mechanic. Table 1 illustrates all of the clues identified, and Body Evolution has a plan in place to address each one to ensure the highest level of customer service is being delivered the very first day of operation.

Table 1: Clue Plan Focal Points for Body Evolution

FUNCTIONAL CLUES	MECHANIC CLUES	HUMANIC CLUES
The Session Itself	The Presentation of the Service	The Service Provider(s)
Productive training sessions	Accessible location to target market	Friendly trainers
Availability of training sessions	Cleanliness – smell and look	Approachability of trainers
Dependability of trainers at sessions	Spacious and not overcrowded	Motivating attitude of trainers
Experienced progression towards goals	Music played during workouts	Personal appearance of trainers
Adequate and functional equipment	Extras available on equipment (TV)	Perceived availability of trainers any time
Appropriate nutritional counseling	Displays of client testimonials	Response time of trainers outside sessions
Clear instructions on exercise & nutrition	Displays of trainer certifications	Attentiveness of trainers during sessions
	Appearance of equipment	
	Availability of showers, changing rooms	
	Attractive and informative business logo	
	Visible signage	
	Informative Website	
	Attractive advertisements	

DISCUSSION & CONCLUSIONS

This paper has presented a more comprehensive way for entrepreneurs to plan their services ventures in order to "get off on the right foot". The integration of customer experience management is imperative in today's competitive environment. Three types of clues are essential to address for any services business. They include functional clues, humanic clues, and mechanic clues.

It is important to remember that services are performances rather than objects, and customers experience intangibles. This forces them to look for clues before and during the service performance that they can evaluate. Customers form overall perceptions of experiences based on the technical performance of the service (functional clues), the tangibles associated with the service (mechanic clues), and the behavior and appearance of service providers (humanic clues). The evaluation of these three clues creates the rational and emotional perceptions of service quality. By definition, a good customer experience is good customer service; the experience is the service. As a result, it is inherently crucial to design and orchestration of these clues as a part of the business plan model.

The value of integrating customer experience management into services plans for new ventures is highly significant. It allows the entrepreneur to solve common customer service issues before they even arise. This means the business can attract and subsequently retain customers from the first day of operation. Generating repeat business is crucial for the survival and prosperity of any small, young business. Developing a plan that integrates customer experience management helps ensure positive customers perceptions, resulting in repeat business and ultimately firm survival.

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