

THE COMMUNITY LAW PROJECT

A GUIDE TO STARTING YOUR BUSINESS

JULY 2015

I. INTRODUCTION

When launching your new business, one of the most important decisions you will make is the choice of legal entity through which you will conduct your business. Determining which legal entity is best suited for your business needs will depend on a number of factors, including the nature of your business, the amount of capital you have available to spend on start-up and administrative costs, your tax goals, your management preferences, whether you desire to expand your business and raise capital and whether there is a high risk of personal liability in your business.

The Law Project has prepared this handbook to provide to you a brief description of the most common business entities available in Illinois and some of the matters you should consider when choosing a form of entity. Please keep in mind that this handbook is provided for informational purposes only and does not constitute legal or tax advice or create an attorney/client relationship. Furthermore, this handbook does not cover all of the matters that you should consider when starting your business. Therefore, we highly encourage you to seek the advice of a qualified attorney and other professionals to assist you in determining the legal entity that is best suited for your business needs. Please also keep in mind that although the same or similar terms may be used to describe entities for corporate law purposes and income tax purposes, the definitions do not necessarily fully overlap and an entity may have one designation for corporate law purposes but another for income tax purposes. For example, a limited liability company could be considered a so-called disregarded entity, partnership, C corporation or S corporation for income tax purposes depending on a number of factors. This guide will provide an overview of both the corporate governance and tax consequences for each choice of legal entity.

II. BUSINESS ENTITY CHOICES

Most small (and not so small) businesses in Illinois are formed as either a sole proprietorship, limited liability company (LLC), or corporation. Although this Guide describes a number of other entities available in Illinois, comparing the relative advantages and disadvantages of these three forms of doing business should be sufficient to help most people select their business entity. In making that decision, it is important to keep in mind that, frequently, there may be more than one entity that could be the “right” answer for a new business. Therefore, the ultimate decision when selecting a business entity will depend on facts specific to that business and the preferences and objectives of its owners. It is also important to keep in mind that the initial choice of a business entity is not necessarily a final one. Rather, as further discussed below, it is not uncommon to change the form of entity over the lifetime of a business, although such changes may have legal and tax implications.

In addition to deciding what kind of entity to use, a related question is the state of formation for the entity. For a small business, the typical state formation is the state in which the business will be based and its owners reside. This Guide assumes that the entity will be formed in Illinois. However, it is common for entities formed outside of Illinois to do business in Illinois. A typical jurisdiction for the formation of such entities is the State of Delaware, which has many business-friendly laws. Any such “foreign” entity doing business in Illinois is generally required to register to do business with the Illinois Secretary of State and pay an annual fee. Although using a foreign entity for a start-up business is typically not recommended because of the additional cost and complexity of filing in two different states, as a business grows there may be reasons to move it to Delaware. As is the case with the related choice of entity question that is discussed in the remainder of

this Guide, it is possible to change the state under the laws of which an entity is organized.

A. Sole Proprietorship

The simplest form of business entity is the sole proprietorship. Technically, a sole proprietorship is not even a business entity as no separate legal entity is formed. Instead, a sole proprietorship is a business that you conduct in your individual capacity. There are virtually no organizational formalities in starting a sole proprietorship if you conduct your business under your real name because in that case you do not need to register your business with the Illinois Secretary of State (however, as is the case in Chicago, registration in your locality may be required). On the other hand, if you conduct your business under an assumed name (i.e., a name other than your real name), you will need to comply with the Illinois Assumed Business Name Act as described in Section III below.

As a sole proprietor in Illinois, you and your business are considered one and the same. In other words, as a sole proprietor, you personally own all of the assets of your business (i.e., all of the assets of your business are held in your name) and you are personally liable for all debts of, and other legal claims against, your business. For example, if a successful lawsuit is brought against your business or your business is unable to pay its debts, then not only your business assets, but also your personal assets (e.g., personal savings, car, home, etc.), could be at risk. This is called “unlimited liability” and is the main reason why most business owners, especially those operating businesses in high risk industries, choose not to structure their businesses as sole proprietorships.

As a sole proprietor, all of the income, gains, deductions and losses, and tax credits of the business are reported directly on your individual income tax return and you are considered self-employed

for tax purposes. A self-employed individual is required to pay self-employment taxes, which effectively replace the employer's and employee's share of payroll taxes and make estimated tax payments.

A person desiring the simplicity of a sole proprietorship in terms of not having a separate income tax return, but concerned about the potential for personal liability for business debts, could consider structuring the business as a single member limited liability company and treating it as a so-called disregarded entity for income tax purposes. A disregarded entity is an entity that exists for state law purposes (e.g., an LLC) but is not treated as a separate entity for income tax purposes (e.g., an LLC with a single owner that elects to be treated as a disregarded entity).

B. Partnerships

Partnerships are defined by the Illinois Uniform Partnership Act (UPA) as an association of two or more persons who are co-owners of a business for profit. So, if you have one or more business partners, the partnership structure may make sense depending on your particular situation.

One advantage of partnerships is that, under the UPA, you and your partner(s) have the power to determine your rights and duties to each other and to the partnership by setting forth those rights and duties in a written partnership agreement. In essence, by entering into a written partnership agreement, you create the "law" under which the relations among you and your partner(s) and between the partners and partnership will be governed subject to the UPA.

It is important to keep in mind that if you choose a partnership structure and do not have a partnership agreement or your partnership agreement is silent with respect to certain matters,

your partnership will be governed by the default rules under the UPA, which may not be favorable depending on your situation. For example, if your partnership agreement does not otherwise provide, you and your partners will share equally in the profits and losses of the partnership even if each partner does not contribute the same amount of capital when starting the partnership. Similarly, absent an agreement to the contrary, any partner can act to bind the partnership to agreements, debts and representations, and any partner can, under certain circumstances, dissolve the partnership without the consent of the other partners. Thus, if you plan to do business as a partnership, you should have a signed agreement defining the partnership's business purpose, the partners' duties, capital and profit sharing and other important matters.

For federal income tax purposes, partnerships are generally considered "pass through" entities because the partnership is not taxed; rather, although the partnership is required to file a tax return, the profits and losses of the partnership pass through to the partners irrespective of whether and when cash or other property is distributed to the partners. This means that a partner may have a current income tax liability on the partner's share of the income of the partnership notwithstanding the fact that there are no current cash distributions being made to the partner. Therefore, you should consider whether your partnership agreement should provide for mandatory tax distributions to fund your tax obligations resulting from your ownership interest in the partnership.

A partner other than a limited-partner in a partnership engaged in a trade or business is considered self-employed for self-employment tax purposes.

A partner may not be eligible for the same kind of tax-advantaged benefit and retirement plans that are available to W-2 employees.

Although a partnership does not pay federal income tax, it may be required to pay entity level state income taxes (for example, Illinois imposes a 1.5% tax on partnership income) as well as non-income taxes.

For legal purposes, a partnership is an entity distinct from its partners. So, for example, property acquired by a partnership is property of the partnership and not the partners individually.

There are three different types of partnerships, which are as follows:

1. General Partnership (GP)

The simplest form of partnership is the general partnership. Like sole proprietorships, general partnerships do not require much formality or preparation and are easy and relatively inexpensive to set up. You can register your general partnership by filing a statement of partnership authority with the Illinois Secretary of State. However, even though highly recommended, a state filing is not required to set up a general partnership. Under the UPA, in the absence of a State filing, if you and the person with whom you are doing business act like partners, you will be deemed to be partners, whether or not you intended to form a partnership.

General partnerships are not popular because, like sole proprietorships, the partners in a general partnership are subject to unlimited liability and, consequently, are held personally liable for the liabilities of the entire partnership if the partnership cannot pay those liabilities. This means that if the business folds, partnership

creditors can pursue collection from a partner and, through legal action, seize or sell a partner's personal assets.

2. Limited Partnership (LP)

The Illinois Uniform Limited Partnership Act (ULPA) defines a limited partnership as a partnership formed by two or more persons under the laws of Illinois that has one or more general partners and one or more limited partners. In order to form an LP in Illinois, you must file a certificate of limited partnership with the Illinois Secretary of State.

A limited partnership differs from a general partnership in that it affords a passive investor (i.e., an investor who is not active in the business) the opportunity to invest capital in a partnership, limit his or her liability to the invested capital, and depend on a general partner to manage the business. In Illinois, the passive investor is called a limited partner and is not personally liable for the obligations of the limited partnership even if the limited partner participates in the management and control of the limited partnership. In contrast, the general partner of an LP has unlimited personal liability and to the extent that the LP has multiple general partners, such general partners will be liable jointly and severally for all obligations of the LP. Often a business entity (e.g., a limited liability company or a corporation) rather than an individual serves as the general partner of the limited partnership in order to limit the liability of the indirect owner(s) of the general partnership interest.

As with a general partnership, your limited partnership should have a written partnership agreement which should cover, at a minimum, (1) the general partner's power, authority and limitations, (2) contributions agreed to be made by each partner (including what happens in the case that additional equity capital is required and not all partners fund the additional capital in

accordance with their ownership interests), (3) any right of a partner to receive, or of a general partner to make, distributions to partners, (4) any power of a limited partner to grant to an assignee of his or her partnership interest the right to become a limited partner, and (5) any event that would result in a dissolution.

If you plan to do business as a limited partnership, the name of your limited partnership must contain the phrase “limited partnership” or the abbreviation “L.P.” or “LP”. If your limited partnership will conduct business under an assumed name, which is a name other than its true name, it must file an assumed name application with the Illinois Secretary of State.

3. Limited Liability Partnership (LLP)

A limited liability partnership is a form of partnership that insulates all of the partners from personal liability for certain partnership obligations. In other words, an obligation of an LLP is solely the obligation of the partnership and not of the partners. A partner in an Illinois LLP, unlike a partner in a traditional general partnership, is protected in certain circumstances from personal liability arising from the negligence, malpractice, or improper conduct of other partners, employees, or agents of the partnership not under the protected partner’s direct supervision and control. The partner is not protected from liability for that partner’s own acts or omissions or for those of someone working under that partner’s supervision or control.

Among the three forms of partnerships, the LLP is the most sophisticated and advantageous structure mainly due to the fact that all partners are shielded from personal liability. This structure is most suitable, however, for professionals (e.g., lawyers, doctors, accountants, etc.) who would like to build a joint practice in a

common field and is generally not recommended for an operating business that carries a trade (e.g., a restaurant).

Qualification as an LLP does not require modification of the existing partnership agreement, except to adopt a name that complies with the statute and filing a “statement of qualification” with the Illinois Secretary of State. Before the “statement of qualification” can be filed though, you need to form a general partnership and obtain a Federal Employer Identification Number (FEIN) for the partnership from the United States Internal Revenue Service (IRS). In Illinois, the name of the LLP must end with “Registered Limited Liability Partnership”, “Limited Liability Partnership”, “R.L.L.P.”, “L.L.P.”, “RLLP”, or “LLP”.

C. Limited Liability Company (LLC)

The limited liability company taxed as a partnership has become, along with corporations taxed as S corporations described below, one of the most preferred types of business entities among owners of privately held businesses. The limited liability company, which can be formed by executing and delivering articles of organization to the Illinois Secretary of State, combines the organizational and operational flexibility of partnerships with the limited liability for all members (i.e., owners) afforded to shareholders of corporations (explained further below). The Illinois Limited Liability Company Act allows the owners of the LLC, subject to certain limitations, to create the laws under which the LLC will be governed by entering into an operating agreement. Operating agreements are not required to set up an LLC, but are highly recommended. Without an operating agreement, the default rules of the Illinois Limited Liability Company Act will govern the LLC and they may not always be favorable to your particular situation.

Another advantage of the LLC is that, unlike a corporation, the LLC is not required to have a board of directors or officers. In the articles of organization you would determine whether the LLC will be managed by one or more members (member-managed), or one or more third party managers (manager-managed) elected by the members. Additionally, members of either member-managed or manager-managed LLCs can in the operating agreement delegate management powers to a board of directors and officers, similar to the structure of a corporation. LLCs are generally cheaper than corporations to set up and operate because there are far fewer filing and reporting requirements. The one exception here is the fact that an LLC operating agreement is typically a more complicated document, and, therefore, more costly to prepare and negotiate than the equivalent documents for a corporation.

Even though the LLC is considered distinct from its owners, for income tax purposes, the LLC is generally treated as a partnership with the same tax treatment described above for partnerships.

Although the typical treatment of an LLC for income tax purposes is a partnership, LLCs can also be treated for income tax purposes as either “C corporations” or “S corporations” described below or, if the LLC has a single owner, it can be considered a disregarded entity as described above.

LLCs can be set up with just one member, unlike partnerships which require more than one owner. Members may be individuals, corporations, partnerships, trusts, associations, or other LLCs. Members may make contributions to the LLC in cash, property, services rendered, a promissory note or other obligation to contribute cash or property, or an obligation to perform services.

In Illinois, the name of the LLC must contain the term “limited liability company” or the abbreviation “L.L.C.” or “LLC”.

D. Corporation

A corporation, which is formed by the filing of articles of incorporation with the Illinois Secretary of State, differs in many respects from the other types of business entities. Illinois law requires that the corporation adopt articles of incorporation, elect directors and officers and fulfill a host of filing and reporting requirements. In addition, Illinois imposes strict rules regarding capitalization requirements and procedural requirements for redemption (having the corporation buy back its stock) and dissolution (terminating the corporation).

The by-laws of a corporation, which are adopted and can be amended by the Board of Directors of the corporation or by vote of the holders of a majority of the outstanding shares, set forth the rules and corporate procedures governing the corporation. The owners of the corporation are referred to as “shareholders” and the Board of Directors and officers of the corporation, rather than the shareholders, manage the operations of the business.

A significant advantage of a corporation is limited liability for all shareholders of the corporation, which means that the shareholders generally will not be liable for the debts and obligations of the corporation. Another advantage of the corporation is that it is considered a separate “person” which exists indefinitely even after the death of its shareholders, directors or officers or the transfer of its shares.

Generally, the main disadvantage of corporations is the fact that they are taxed separately from their owners, resulting in taxation first of the corporation’s profits and then again of the

dividends paid by the corporation to its shareholders. Such double taxation occurs with respect to “C corporations”. However, a corporation that meets certain tax law requirements may elect to be an “S corporation,” which is treated as a pass-through entity for federal income tax purposes. Although such pass-through treatment is similar to that for partnerships described above (including the imposition of state entity level taxes) there are some differences. The main difference is that an S corporation is a much less flexible mechanism for achieving pass-through treatment than a partnership or an LLC treated as a partnership for income tax purposes. To qualify as an S corporation, a number of tax law requirements must be met, such as a limit of 100 shareholders, a limit on permitted shareholders (generally only individuals and certain types of trusts) and a requirement that the corporation only have a single class of stock (although voting and not-voting stock is permitted). However, owners of an S corporation (unlike owners of a partnership or an LLC treated as a partnership) can be W-2 employees of the S corporation.

Corporations that operate multiple businesses often separate those businesses into separate corporations or LLCs called subsidiaries. This allows each business to limit its liability and focus management responsibilities.

Summary

The following table summarizes the significant features of the different types of business entities in Illinois:

	Sole Proprietor	General Partnership	Limited Partnership and Limited Liability Partnership	Limited Liability Company	S Corporation	C Corporation
Owners	One	Two or more	Two or more	One or more	One or more	One or more

A Guide to Starting Your Business

	<u>Sole Proprietor</u>	<u>General Partnership</u>	<u>Limited Partnership and Limited Liability Partnership</u>	<u>Limited Liability Company</u>	<u>S Corporation</u>	<u>C Corporation</u>
State Filing to Form	No	No	Yes	Yes	Yes	Yes
Personal Liability	Yes	Yes	to General Partners only	None	None	None
Management	Self	Co-Partners	General Partner	Members or Managers	Directors and Officers	Directors and Officers
Person Taxed on Entity Income	Self	Co-Partners	Co-Partners	Members	Shareholders	Corporation & Shareholders on Distribution
Person Deducting Entity Losses	Self	Co-Partners	Co-Partners with limitation	Members with limitation	Shareholders with limitation	Corporation
Tax on Entity Distributions	No	No	No	No	No	Yes
Tax treatment of equity owners that provide services	Self-employed	Self-employed	Self-employed (GP) and W-2 (LP)	Self-employed (some take position that LP W-2 rule should apply)	W-2 Employee	W-2 Employee
Restrictions on classes of units/shares	N/A	No	No	No	Single class of stock (voting and non-voting permitted)	No
Restrictions on owners	None	None	None	None	100 or fewer U.S. individuals and certain trusts	None

Changing Forms of Business Organization

A decision to be a general partnership, a limited partnership, an LLP, an LLC, or a corporation is not an irreversible decision. Illinois law allows business entities to change their form through the process of either merger or conversion. A general partnership or a

limited partnership may convert to an LLC or merge into or with an LLC. A general partnership may become an LLP. In the case of a merger, either an LLC or a partnership may be the surviving entity. Also, an LLC can merge into or with a corporation, and either an LLC or a corporation may be the surviving entity.

In other words, the type of business entity that you start with can evolve as your business and its needs change. Although an entity can be converted for corporate law purposes relatively easily, depending on the direction of a conversion, a conversion may have significant tax implications. For example, a sole proprietorship, partnership or LLC treated as a partnership can generally be converted into a corporation (either a C corporation or, assuming that the specific requirements for an S corporation are satisfied, an S corporation) but a C corporation or an S corporation generally cannot be converted into a partnership or a disregarded entity without triggering tax.

III. FILING AND REGISTRATION REQUIREMENTS

The following summarizes some of the filing and registration requirements required under Illinois law.

- Illinois Department of Revenue—You must obtain an Illinois Business Tax number (IBT) and pay retail and occupation tax if you plan to hire employees, buy/sell products wholesale/retail, or manufacture goods.
- Illinois Secretary of State—Corporations, limited liability companies, limited partnerships and limited liability partnerships must register in Illinois. Corporations and LLCs must also register any assumed name with the Illinois Secretary of State.

A Guide to Starting Your Business

- **County Clerk**—If you are a sole proprietor or a partnership and you conduct business in Illinois under an assumed name (i.e., a name other than your own real name), file for an Assumed Name Certificate with the County Clerk of the County in which you conduct your business. Within 15 days of filing the Assumed Name Certificate, you must publish your assumed name in a local newspaper under Legal Notices for three consecutive weeks. Proof of publication must then be filed with the County Clerk within 50 days of filing the Assumed Name Certificate. Unless proof of publication is made to the County Clerk, the Assumed Name Certificate is void and you can be held criminally liable for failure to comply with the Illinois Assumed Business Name Act.
- **Local Business License**—Unless otherwise exempted by state law, all persons who operate a business or occupation are required to obtain a business license from the city, town or village in which the business is located. In Chicago, business tax registration is completed as part of the business license application process. A separate license is required for each business location in the City of Chicago.
- **Federal Employer Identification Number (FEIN)**—If you operate your business as a “C” or “S” corporation, or as a partnership or an LLC that will have employees, you will need to obtain a Federal Employer Identification Number. You may register for an FEIN with the IRS.

A Guide to Starting Your Business

Government Branch	Phone	Address	Registration
Illinois Department of Revenue http://tax.illinois.gov/taxforms/reg/reg-1.pdf	(800) 732-8866; (217) 782-3336	100 W. Randolph Chicago, IL 60601	Illinois Business of Tax (IBT) Form REG-1
Illinois Secretary of State www.cyberdriveillinois.com/departments/business_services/home.html	(312) 793-3380	69 W. Washington St., Ste. 1240 Chicago, IL 60602	Incorporation Limited Partnership and LLC organization
Office of the Cook County Clerk Bureau of Vital Records www.cookcountyclerk.com/vitalrecords/busnamereg/Pages/default.aspx	(312) 603-5652	50 W. Washington St. East Concourse Level - 25 Chicago, IL 60602	Cook County Assumed Name
City of Chicago Small Business Center www.cityofchicago.org/city/en/depts/bacp/sbc/business_licensing.html	(312) 744-6249	City Hall 121 N. LaSalle Room 800 Chicago, IL 60602	Local Business License (Chicago)*
Federal Tax Payer Service www.irs.gov/businesses/small/article/0,,id=102767,00.html	(800) 829-1040	230 S. Dearborn Chicago, IL 60604	Federal Employers Identification Number (FEIN)

*Please contact the municipal government of the relevant city, town, or village for further information about obtaining a business license and business tax registration.

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