

LEGAL STRUCTURE IN A NUTSHELL

This is a distillation of key points from the companion article on “Selecting the Legal Structure for Your Business.”

Three Important Questions to Consider:

1. Will you have partners other than a spouse?
2. Do you have significant personal assets you need to protect?
3. Will you have risks that cannot be covered by insurance?

If you answer “yes” to any of these questions, you will probably want to form a more formal legal entity, such as a corporation or a limited liability company (LLC). Otherwise, consider the simplicity of:

Sole Proprietorship

A great way to get started.

Pros

1. Easiest and least expensive legal structure to form and maintain
2. No double taxation of income – profits or losses flow through to personal tax return
3. Requires only your social security number until you hire employees
4. All profits are yours
5. All decisions are yours
6. You are capable of fast, flexible response

Cons

1. Unlimited, personal liability for debts of the business
2. Company dies when you die
3. Less availability of capital

Note: If you operate under a name other than your own, you need to register the “assumed name” with your County Clerk.

Partnerships

Need help or money to get going? Partners can help, but approach partnerships with care and professional advice.

Pros

1. More capital available and a wider range of skills

2. Direct sharing of profits – profits and losses flow through to personal tax returns
3. No double taxation of income
4. Flexible allocation of income and deductions is possible

Cons

1. Unlimited liability for general partners
2. Death or exit of a general partner dissolves the partnership
3. Buying out a partner can be difficult

Note: A written partnership agreement is strongly advised.

Corporations

“C” versus “S”, that is the question. But a C (taxable) corporation must be formed before you can elect S status for pass-through treatment of profits and losses. So consider first. . .

Pros for a C-Corp

1. Limited stockholder liability – only your investment is at risk
2. Unlimited corporate life – ownership is transferrable
3. Flexibility in raising capital using different classes of stock, such as preferred

Cons for a C-Corp

1. Double taxation – first at the corporate level, then at the stockholder level on dividends
2. More expensive and complex to form and administer, compared to a sole proprietorship
3. Activities limited by the corporate charter
4. The larger the corporation, the more regulated it is

S-Corps are the same as C-Corps except that they are taxed only once by passing through profit or loss directly to the shareholders – like a partnership.

Pros of S-Corps

1. Limited stockholder liability – same as for C-Corps
2. Unlimited corporate life – same as for C-Corps
3. No double taxation of corporate income (except by the State of Illinois)
4. Flexible mix of dividends and salary possible for shareholders who are also employees

Cons of S-Corps

1. Only one class of stock allowed, so no flexibility in allocating income and deductions
2. Significant restrictions on who can own shares – an issue in mergers and acquisitions
3. Carryover of certain C-Corp tax attributes, suggesting S status should be elected in first year

Limited Liability Company (LLC)

An LLC is a new alternative to the S-Corp, providing partnership tax advantages with more flexible ownership and distribution of profits and losses.

Pros

1. Limited member liability – only your investment is at risk
2. Special income and deduction allocations possible – similar to partnerships
3. No ownership restrictions, compared to S-Corps

Cons

1. Members pay self-employment taxes on their share of earnings – no dividend option
2. Too new to have much case law available for commercial dispute resolution
3. Higher legal and accounting costs than for the typical small corporation

Which is better – S-Corps or LLCs?

It depends. And we strongly urge you to consult both your attorney and tax accountant to determine the best form for you. Consider:

1. Whether owners should be compensated in proportion to their ownership (S-Corp) or by some other criteria (LLC).
2. Whether owners need to include non-resident aliens, other business entities, etc. (LLC) or not (S-Corp).
3. Whether owners seek to minimize employment taxes (S-Corp) or not (LLC).

Corporate Formalities must be followed throughout the life of corporations and LLCs to minimize the risk of creditors “piercing the corporate veil” to gain access to the personal assets of the owners.

Much more depth is provided on the topics covered here in the companion article, “Selecting the Legal Structure for Your Business.”

The foregoing outline – and the companion article “Selecting the Legal Structure for Your Business” – are not intended to constitute legal or tax advice. In view of the important legal, tax and business planning issues involved, the reader is strongly advised to consult with a business attorney and certified public accountant for appropriate advice on such matters.

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