

SELECTING THE LEGAL STRUCTURE FOR YOUR BUSINESS

SCORE Fox Valley Chapter, September 26, 2009

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Introduction and Questions to Consider

An important element of your strategic planning is the selection of the legal structure for your business. There are many reasons for owners of small businesses to examine the various available forms of business organization. These include changing tax laws, limitation of personal liability for debts and obligations of the business, and availability of capital. Your choice of business form will impact your exposure to personal liability, how you withdraw profits from the business, payment of income taxes on the earnings of the business, ability to source and raise capital, and how the business is run.

Changes in the legal structure of your business may occur after the startup phase. However, it is usually best that any changes be made at the beginning of a new year. Many small businesses start out as sole proprietorships (defined as a business owned by one person) and later, once established, reorganize as either an S corp or a limited liability company (LLC) in order to limit the personal liability of their owners. The decision of whether to start out as a sole proprietorship or to organize as either an S or LLC immediately generally will depend upon your answers to the following questions:

1. **Will you have partners (other than your spouse)?** If so, you will want to organize immediately rather than wait because in a partnership, like a sole proprietorship, there is no distinction between the business and its owners. When there is more than one owner in an “unincorporated” business, it becomes a general partnership where each of the partners is jointly and severally liable for all of the debts of the business and the acts of all of its partners. From a personal liability standpoint, a general partnership is absolutely the worst business form.
2. **How much personal wealth do you as the owner have?** Once again, because there is no distinction between the business and its owner, in a sole proprietorship all of your personal assets (and those of your spouse, if jointly owned) will be at risk.
3. **Are there risks in your business that cannot be covered by commercial insurance?** Every business should carry commercial insurance. However, standard public liability policies exclude coverage for errors and omissions (malpractice). This

type of coverage is available but at a significant premium cost depending upon the type of business. If you have, or anticipate having a substantial risk of malpractice, then immediate organizing as a corporation or an LLC would be the prudent decision.

Absent a reason for organizing as a corporation or LLC at the time the business is, the sole proprietorship is usually a workable interim solution. It is easy to form and dissolve. There is little to minimum government regulation. The income tax rules and regulations are relatively straightforward. If the business is successful as planned, you can elect to reorganize as a corporation or LLC after the first 12 to 18 months. However, as indicated above, changes in legal structure are best made at the beginning rather than during the year.

Clients should obtain professional assistance from both an attorney who works with small businesses and an accountant in conjunction with decisions as to which form of legal entity best meets their business and tax planning needs.

This article will review each of the major forms of business legal entity structures: (1) sole proprietorships, (2) partnerships, (3) taxable or C corporations, (4) S corporations, and (5) limited liability companies or LLCs. It will cover information about the formation and administration of each, the major advantages and disadvantages of each, tax consequences, and other related topics relevant to making an appropriate decision about which legal form best meets the needs of your business and your tax planning.

Sole Proprietorships

A sole proprietorship is an unincorporated business owned by one person. It is the simplest form of business organization to start, to maintain, and to dissolve. The business has no legal existence apart from that of the owner. Its liabilities are the owner's liabilities. The personal assets of the owner (and spouse if jointly owned) are at risk to creditors and claimants of the business.

There are typically no regulatory or governmental requirements to be met to start up a sole proprietorship. The owner decides that he or she is in business and indeed he or she is in business. One major exception is if the business will operate under a different name than the legal name of the owner, requiring registration under the Illinois Assumed Name statute (see discussion page 3).

Because there is no legal distinction between the owner and a business organized as a sole proprietorship, there is no double taxation of income. The owner reports the income and expenses of the business on Schedule C "Profit or Loss from Business" of the Form 1040, "U.S. Individual Income Tax Return". The profit or loss from Schedule C is combined with the other income of the owner to compute adjusted gross income (AGI) and federal taxable income. Profit or loss from the business also affects Illinois income tax liability since federal AGI is the starting point for computing the state's income tax liability.

Caution: the "hobby loss rules" restrict how long a business can operate at a loss without the risk of the IRS recharacterizing it as a not for profit activity. The general rule is that the business should be profitable in three of five consecutive years ending with the most recent year.

More than \$400 profit on the Schedule C triggers the 15.3% self-employment (SE) tax. SE tax is double W-2 FICA (Social Security and Medicare) because it includes the employee and the employer's matching share. The limit and rate for SE tax is indexed annually. SE tax is reported on Schedule SE, "Self-Employment Tax" and is an additional tax liability reported on the 1040. Depending upon other income subject to withholding (W-2 salary or wages), the owner may be required to pay quarterly federal and state income tax estimates to avoid underpayment penalties. SE tax is part of the quarterly estimated federal tax payments.

Advantages of Sole Proprietorships

- **Ease of formation:** There is less formality and fewer legal restrictions associated with establishing a sole proprietorship. Little or no governmental approval is required. It is less expensive to form and maintain than is a partnership, corporation, or limited liability company.
- **No double taxation of income:** Because there is no legal distinction between the business and its owner, only the owner is taxed on the earnings of the business.
- **No separate taxpayer identification number:** Unless the business will have employees, generally, the owner will use his/her social security number as the taxpayer identification number for the business. (Refer to www.irs.gov for additional information regarding Employer Identification Numbers or EINs.)
- **Sole ownership of profits:** The owner does not share profits of the business with anyone else.
- **Control over decision making:** There are no co-owners or partners to consult in making decisions.
- **Flexibility:** The owner is able to respond quickly to changing business needs in day-to-day management decision making.

Disadvantages of Sole Proprietorships

- **Unlimited liability:** The owner is personally responsible for all of the debts of the business, and all personal assets (house, cars, investments, etc.) are at risk.
- **Limited business life:** The business usually terminates upon the death of the owner.
- **Less availability of capital:** Capital for sole proprietorships is dependent on the owner's assets and credit. Long-term financing can be more difficult to obtain.

Assumed Names

If the legal name of the business will be different than the owner's name (e.g., Bob Smith versus Bob Smith d/b/a Acme Appliance Services), the Illinois Assumed Name Act requires that sole proprietorships using an assumed name are to register the name with the County Clerk's office of the county where the business is located.

- **Filings apply only to a county.** If the business will have locations in more than one county in Illinois, it will need to make a similar filing in each of the additional counties where it will have a business location.
- **Do a broad search when selecting an assumed name:** The County Clerk will only know that the name being registered is not being used in the county. Do a wider search by going to the Illinois Secretary of State's corporation and LLC registry (at www.cyberdriveillinois.com). That will reveal if there is any corporation or LLC registered within the state using the same or similar name. You may also need to check the federal trademark registry at www.uspto.gov. It always is a good idea to perform an Internet search to spot potential conflicts before you settle on a name.

- **Process:** The notice of filing will be prepared by the County Clerk to be published once a week for three consecutive weeks in a newspaper of general circulation published within the county.
- **Banks require a certificate of assumed name:** Many banks will not open a commercial checking account in the name of the business using an assumed name without the owner presenting the certificate issued by the County Clerk.

The County Clerk telephone numbers and addresses for Cook and the collar counties in the metropolitan Chicago area are:

Cook	(312) 603-5656 69 West Washington Street, 5th Floor Chicago, IL 60602
DeKalb	(815) 895-7149 110 E. Sycamore Street Sycamore, IL 60178
DuPage	(630) 407-5500 Jack T. Knuepfer Administration Building, First Floor 421 N. County Line Road Wheaton, IL 60187
Kane	(630) 232-5950 719 S. Batavia Road, Building B (North Entrance) Geneva, IL 60134
Kendall	(630) 553-4104 111 West Fox Street Yorkville, IL 60560
Lake	(847) 377-2400 18 North County Street, Room 101 Waukegan, IL 60085
McHenry	(815) 334-4242 2200 N. Seminary Avenue Woodstock, IL 60098
Will	(815) 740-4615 Main Office 302 North Chicago Street Joliet, IL 60432

Useful publications from the IRS include:

Publication 334, "Tax Guide for Small Business" (For Individuals Who Use Schedule C or C-EZ)

Publication 583, "Starting a Business and Keeping Records"

Publications can be downloaded in PDF format from www.irs.gov or ordered by calling the IRS Central Distribution Center at 1-800-829-3676. In addition, the IRS has a "Small Business Resource Guide" that is updated annually that can be accessed from their web site. Information about the guide can be found towards the end of Pub 334.

Partnerships

A partnership is an unincorporated legal entity between two or more persons who join to carry on a business or trade. Each contributes money, property, labor, or skill and expects to share in the profits or losses of the business. As with sole proprietorships, there is no legal distinction between the partnership and its partners. Consequently, each partner has unlimited liability for the debts of the business, and all personal assets are at risk. However, each partner is also jointly and severally liable for all of the debts of the business and acts of all of the partners.

Joint and several liability is the reason for our earlier statement that from a personal liability standpoint, general partnerships are the worst form of business organization. However, there are several types of businesses where general partnerships have been the norm or there are other legal and regulatory reasons that they are used, the discussion of which is beyond the scope of this section. Moreover, the income tax rules that govern general partnerships are the same ones that govern multiple owner limited liability companies. Therefore, we are including partnerships in the discussion of different legal entity forms for business.

A variation of general partnerships is the limited partnership. There will be one or more general partners (often the general partners will be corporations) who have full liability and are the managers of the partnership. Then, there can be any number of limited partners (usually investors) whose liability is limited to the amount of their investments. The income tax “at risk” and “passive activity loss” rules limit the amount of losses that limited partners can use to offset other sources of taxable income.

From an income tax standpoint, partnerships are pass-through entities. As with sole proprietorships, the profits or losses of the business are taxed at the individual partner level based on the proportional ownership interests of the partners. Special income allocation rules are available to partnerships whereby distribution of income and losses do not have to follow ownership interests, if there is an economic reason for a different distribution. (This feature is one of the advantages of the LLC over the S corp where there are multiple owners.)

The partnership files a Form 1065, “U.S. Partnership Tax Return” which distributes the partnership’s tax items to the individual partners on their Schedule K-1s, “Partner’s Share of Income, Deductions, Credits, Etc.”. The profit or loss passed through on the K-1 is reported on Page 2 of Schedule E, “Supplemental Income and Loss” of the individual partners’ 1040 returns.

General partners ordinarily will be able to use partnership losses that are passed through to offset other sources of taxable income. However, limited partners’ losses are classified as passive and can only be used to offset other sources of passive income. **Caution:** as with sole proprietorships, the partnership form is subject to the “hobby loss rules” discussed above in the previous section.

Guaranteed payments to limited partners – and the Schedule K-1 profit from a trade or business and guaranteed payments, if any, for general partners – are subject to the same 15.3% self-employment tax rules as with a sole proprietorship. Estimated quarterly tax payments also may be required for both federal and state income tax purposes.

Partnership business structures are extremely complex from an income tax perspective, and those involved with these structures are well advised to retain the services of expert legal, accounting, and tax advisors.

In forming partnerships, general or limited, negotiation of a partnership agreement should be undertaken and completed prior to the formation of the partnership.

Advantages of Partnerships

- **Power in numbers:** Partners with different skills and expertise can potentially leverage all of the partners' efforts (i.e., so that 1+1 equals 3 or more). More capital and a better range of skills are possible than with the sole proprietorship form.
- **Direct rewards:** Partners who participate in the business are motivated to apply their best abilities through the direct sharing of profits of the partnership.
- **No double taxation of income:** Profits of the partnership are taxed only at the partner level.
- **Flexible allocation of income and deductions:** Allocations and distributions do not have to follow ownership interests (as they must in an S corp).

Disadvantages of Partnerships

- **Unlimited liability for general partners:** All partners in a general partnership and general partners in a limited partnership have joint and several liability for all of the debts of the business, and their personal assets are at risk.
- **Limited life:** The death or exit of a general partner usually dissolves the partnership. The business may continue to operate based on the creation of a successor partnership. Partnership insurance should be considered.
- **Difficulty of disposing of partnership interests:** The buy-out of a partner may be difficult unless specifically provided for in the written partnership agreement.

Assumed Names: Partnerships are subject to the Illinois Assumed Name Act (see above discussion under sole proprietorships, page 3).

For more information regarding limited partnerships, contact the Illinois Secretary of State:

501 South Second Street
Room 328, Howlett Building
Springfield, IL 62756
(217) 782-6961
Hours: 8 A.M. - 5 P.M. Mon-Fri

69 W. Washington
Suite 1240
Chicago, IL 60602
(312) 793-3380
Hours: 8 A.M.-5 P.M. Mon-Fri

www.cyberdriveillinois.com

Useful IRS publications on partnerships include:

Pub 541, "Partnerships"

Corporations and Limited Liability Companies (LLCs)

In contrast to the sole proprietorship and partnership business organizational forms that we have been discussing where there is no legal distinction between the business and the owner(s), we will now be moving into three other forms that are separate and distinct from that of the owners. The legal distinction feature supports the inherent advantage of these latter forms over the former in terms of limiting the personal liability of the owners for the debts of the business.

A brief summary of each is as follows:

- **C or Taxable Corporation:** Organized under state law. Limits shareholder liability to their stock investment. In exchange for limited liability, it suffers the disadvantage of double taxation of corporate income. Corporations can be as small as a single shareholder who also serves as the Board of Directors, officers, and employee of the corporation all the way up to the largest Fortune 500 publicly owned multinational business enterprises. The same type of corporate formalities applies to the one person operation as with the largest entities. While seemingly a matter of “form over substance” as they apply to small corporations, these formalities nonetheless must be followed diligently throughout the life of the corporation to minimize the potential for “piercing the corporate veil” that protects shareholders from personal liability.
- **S Corporation:** A taxable or C corp which elects partnership pass-through tax treatment of the earnings and losses to its shareholders based on their stock ownership percentages by filing a special election with the IRS. There are restrictions as to the number and type of shareholders and class of capital stock permitted that is imposed by the Internal Revenue Code and IRS regulations. Other than for the pass-through tax treatment feature, all of the same types of legal formalities and state and local regulations that apply to C corps also apply to S corps.

Shareholders who work for the corporation are W-2 employees rather than being classified as self-employed individuals subject to the self-employment (SE) tax. This feature gives rise to flexibility in compensation of shareholders (which will be discussed later).

- **Limited Liability Company (LLC):** A relatively recent hybrid organizational structure that combines the limited liability advantage of corporations with partnership pass-through tax treatment. LLCs are organized under state LLC laws, many of the provisions of which are similar to the corporation laws. Corporate formalities should be followed. From a non-tax standpoint, LLCs are subject to the same rules and regulations as C and S corps.

The principal advantage of the LLC form over S corps is there are no limits on number of members (the LLC equivalent of corporate shareholders) and restrictions on type of owners. Also, are able to use special income and deduction allocations allowed under partnership tax law and regulations that are not available to S corps. Generally, LLCs are the legal entity of choice to hold real estate investments.

Sole member LLCs are taxed the same as sole proprietorships. Multi member LLCs are generally taxed as partnerships subject to the SE tax on the allocations of partnership income and any guaranteed partnership payments.

Corporations

A corporation is a separate legal entity, distinct from the individuals who own it (known as the shareholders). This is in contrast with both sole proprietorships and partnerships which are not separate legal entities from their owners. Corporations are formed by the authority of the Secretary of State of the state where the corporation will be organized. In the case of an Illinois corporation, the incorporating individual or individuals (referred to as incorporators) file Articles of Incorporation with the Business Services Department of the Illinois Secretary of State's office. Incorporation is effective the date that the Secretary of State issues the "Certificate of Incorporation".

Caution: Contracting involving the corporation should be undertaken only after the incorporation effective date as shown on the Certificate of Incorporation issued by the Illinois Secretary of State.

Because the corporation is a separate and distinct entity from that of its shareholders, it limits the liability of the shareholders, thus overcoming the principal disadvantage of the sole proprietorship and general partnership forms of business organizations that have already been discussed. However, in exchange for limited liability, there is a well established set of practices known as "following corporate formalities" that must be diligently adhered to throughout the life of the corporation to minimize the risk of third party creditors and other claimants being able to successfully "pierce the corporate veil" to access the personal assets and wealth of the owners (more on this important subject matter later).

The principal disadvantage of a corporation is that because it is legally a separate entity, it is also a separate entity for income taxation. The profits of the corporation are first taxed at the entity level for federal and state purposes. Then, when dividends are paid to the shareholders, they constitute taxable income to the shareholders without any offsetting deduction for the corporation because dividends are a return of capital rather than the payment of interest. This is what is commonly referred to as double taxation of C or taxable corporations. Losses generated by corporations likewise are retained at the legal entity level and are used to either offset taxable income in earlier years or are carried forward to future years under the Internal Revenue Code rules and regulations.

Advantages of C or Taxable Corporations

- **Limited stockholder liability:** Absent a successful corporate veil piercing judicial action, stockholders' risk is limited to their investment in the shares of the corporation.
- **Unlimited corporate life:** The life of a corporation is not dependent upon its shareholders, since their interests are transferable. Therefore, the death or exit of a shareholder, even one with a controlling interest, does not, in and of itself, terminate the corporation. Maximum corporate life is established by the state corporation laws. The life of a corporation can be perpetual.
- **Ability to raise capital:** Additional shares can be sold to existing and new shareholders. C corps can go public through IPOs (Initial Public Offerings). Flexible capital structures are possible with the use of preferred stock. Last, particularly larger corporations will be able to access the capital markets.

Disadvantages of C or Taxable Corporations

- **Double taxation of income for the shareholders:** Corporate profits are taxed at the entity level. Dividends are taxable income to the shareholders without any offsetting deduction available to the corporation.

- **Forming and administering a corporation is expensive:** Compared to sole proprietorships, there is a sequence of steps that must be followed to create the corporate entity. Then, there is a prescribed set of corporate formalities that must be followed throughout the life of the corporation. And, at the end of its life, the corporation must be dissolved, assets disposed of, and liabilities settled.
- **Activities are limited by the corporate charter and law:** The corporation can only engage in those activities that were specifically spelled out in its Articles of Incorporation and the state's corporation law.
- **Extensive governmental regulations:** By both the nature of the legal and tax entity and the typical larger, more extensive operations, corporations can be subject to a multitude of national, state, and local regulations.

Steps in Forming an Illinois Corporation

Caution: Corporations should be organized with the assistance of legal counsel. Legal counsel should also be involved throughout the life of the corporation.

1. **Negotiate shareholder agreement:** If there will be multiple shareholders, it is a good idea to negotiate the shareholder agreement **before rather than after** incorporation. A shareholder agreement is, most importantly, a buy-sell agreement. It should always be negotiated at the front end when all of the shareholders are on friendly terms. If agreement cannot be reached, then it may be possible to set up separate corporations, using one as a "fronting" company and each of the others working with the fronting company on a corp-to-corp basis, thus, creating a "virtual" firm.

When the shareholders are family members, there are special provisions under the Internal Revenue Code's "related party rules" that require working with experienced tax counsel.

2. **Select a name for the corporation:** The next step is to check the Illinois Secretary of State's web site at www.cyberdriveillinois.com to determine if the name or a closely resembling name has already been filed. It is possible that the name of the sole proprietorship, if it is being incorporated, can be adapted for corporate use. See earlier comments about reviewing the state corporation and LLC database when selecting a name to be registered under the Illinois Assumed Name Act.

It may also be necessary to check for any possible trademark infringement issues, which legal counsel can perform. Performing an Internet search for potential conflicts should always be part of the due diligence process in selecting a corporate name. The U.S. Trademark Registry can be searched at www.uspto.gov.

Being able to secure related domain names (URLs) for use as Internet addresses may also be important as you settle on a name for your company. .

Legal counsel will take the necessary steps to reserve the selected name with the Illinois Secretary of State.

3. **Prepare Articles of Incorporation:** Legal counsel will prepare Form BCA-2.10, "Articles of Incorporation" that all incorporators must sign. A couple critical sections of the form are the designation of the registered agent and the purpose for organizing the corporation.

All corporations must have a registered agent in order that there is a person to contact for serving process on the corporation (i.e., lawsuits). Frequently, it is one of the incorporators who is designated as registered agent. Other times, legal counsel prefers to be the registered agent.

The purpose for organizing the corporation should be as broad as possible to avoid the potential problem of “ultra vires” acts (i.e., activities that are beyond the corporation’s powers). Narrowly defined language in the Articles of Incorporation risks being overlooked as the business activities change over time, which would require filing amended Articles of Incorporation with the Secretary of State. Legal counsel will add omnibus language to the purpose section that allows the corporation to engage in any and all activities that are authorized under current and future corporate law.

4. **File the Articles of Incorporation with the Secretary of State:** Legal counsel ordinarily will use expedited filing. Time is of the essence in getting the Articles filed. The corporation does not come into existence until the Secretary of State issues the Certification of Incorporation. Shareholders will not have liability protection for activities of the business prior to the date of the Certification of Incorporation.

The initial Illinois Franchise Tax is assessed on the corporation’s planned paid-in capital (number of shares x par value per share + paid-in surplus or the per share value in excess of the par value).

Contact information for the Secretary of State’s Business Services:

501 South Second Street
Room 328, Howlett Building
Springfield, IL 62756
(217) 782-6961
Hours: 8 A.M. - 5 P.M. Mon-Fri

69 W. Washington
Suite 1240
Chicago, IL 60602
(312) 793-3380
Hours: 8 A.M.-5 P.M. Mon-Fri

www.cyberdriveillinois.com

5. **File a copy of the Certificate of Incorporation with the County Recorder of Deeds:** A copy of the certificate must be filed in the county where the registered agent is located. It is filed with the County Recorder of Deeds and **not** the County Clerk, as is the case of a sole proprietorship using an assumed name.

Cook County (312) 603-5050
Downtown County Building
118 N. Clark Street, Room 120
Chicago, IL 60602

De Kalb County (815) 895-7156
110 E. Sycamore Street
Sycamore, IL 60178-1448

DuPage County (630) 407-5400
TDD: (630) 407-5399
Jack T. Knuepfer Administration Building, First Floor
421 N. County Farm Road
Wheaton, IL 60187

Kane County	(630) 232-5935 719 N. Batavia Avenue, Building C Geneva, IL 60134
Kendall County	(630) 553-4104 (County Clerk and Recorder in same office) 111 W. Fox Street Yorkville, IL 60560
Lake County	(847) 377-2575 18 N. County Street, 2nd Floor Waukegan, IL 60085
McHenry County	(815) 334-4110 Administration Building 667 Ware Road Woodstock, IL 60098
Will County	(815) 740-4637 58 East Clinton Street Joliet, IL 60432-4143

6. **Hold Initial Meeting of Shareholders:** Following incorporation, the first corporate formality is for the shareholders to formally adopt the by-laws of the corporation, subscribe to their shares of stock, and elect the Board of Directors. There can be as few as one shareholder who will elect himself or herself as the sole director. Or there can be any number of shareholders who may or may not serve as board members. The by-laws are the “rules of the road” that the corporation will follow throughout its life until amended. Importantly, the minutes of the meeting must be dated and in writing, which gets filed and maintained with the corporate records.
7. **Hold initial meeting of the Board of Directors:** Following the adjournment of the initial shareholders’ meeting, the Board of Directors will convene their initial meeting. Their agenda will include appointment of officers, setting of officer compensation, and approval of any other resolutions for matters requiring board approval (this will include the required bank resolution to open up the corporation’s commercial checking account).

The minimum number of required corporate officers is three – the president, secretary, and treasurer. In a one-person corporation, the same person will fill all three positions. The by-laws can provide for any number of additional officers.

The by-laws adopted by the shareholders spell out the duties and responsibilities of the directors. As with the minutes of the shareholders’ meeting, the minutes of the directors’ meeting must be in writing and certified by the corporate secretary. The original is filed with the corporate records.

8. **Apply for Employer Identification Number:** Because the corporation is a separate legal entity for tax purposes, it must be assigned an Employer Identification Number (EIN) by the IRS. This should be done as soon as possible following receipt of the Certificate of Incorporation from the Secretary of State. File either Form SS-4, “Application for Employer Identification Number” or file online. (For additional information, refer to www.irs.gov.)

The IRS will issue a written confirmation with the assigned EIN and the corporation's responsibility for the returns to be filed:

Form 941, "Employer's Quarterly Tax Return" due 04/30, 07/31, 10/31, and 01/31
 Form 940, "Employer's Annual Federal Unemployment (FUTA) Tax Return" due 01/31
 Form 1120, "U.S. Corporation Income Tax Return" due 03/15

The IRS will also place the corporation on the distribution list for Form 8109-C, "Federal Tax Deposit Coupon Book" to be used to deposit 941 withholding tax and 940 FUTA tax. Electronic transfer is an encouraged option and depending upon the annual dollar amount of withholding is a mandatory requirement. (Refer to IRS Publication 15, "Circular E, Employer's Tax Guide" for additional information. Pub 15 is updated annually and can be obtained from the IRS Central Distribution Center by phoning 1-800-829-3676 or by downloading in PDF format from www.irs.gov.)

Local IRS Offices:

2001 Butterfield Road
 Downers Grove, IL 60515
 (630) 493-5291
 M - F 8:30 AM - 4:30 PM

230 S. Dearborn Street
 Chicago, IL 60604
 (312) 566-4912
 M - F 8:30 AM - 4:30 PM

9. **Apply for state taxpayer identification number:** Following assignment of the federal EIN by the IRS, register the corporation with the Illinois Department of Revenue by completing and filing Form REG-1, "Illinois Business Registration Application". The blank form can be downloaded from www.tax.illinois.gov or it can be filed online or in person at a local office of the Department of Revenue:

Maine North Regional Office
 9511 Harrison Avenue
 Des Plaines, IL 60016-1563
 Phone: (847) 294-4420
 8:30 AM to 5 PM

James R. Thompson Center
 Concourse Level
 100 West Randolph Street
 Chicago, IL 60601-3274
 Phone: (312) 814-5232
 8:30 AM to 5 PM

Registration with the Illinois Department of Revenue is required in order to remit state income tax withheld from employee gross pay and sales taxes collected on taxable sale of product and merchandise. The taxpayer number serves as the resale exemption number provided to vendors of merchandise purchased for inventory and resale to avoid double payment of the state sales tax.

10. **Register with the Illinois Department of Employment Security:** Having Illinois domiciled employees subjects the corporation as an employer to the state unemployment tax (SUTA). Following issuance of the state taxpayer number by the Illinois Department of Revenue, the corporation files Form UI-1, "Report to Determine Liability Under the Unemployment Insurance Act" with the Illinois Department of Employment Security. The form can be downloaded from www.ides.state.il.us or by calling the agency's hotline at 1-800-247-4984 or at 1-312-793-4880 (option 1). It can also be filed online.

Illinois Department of Employment Security Administrative Offices:

33 South State Street
 Chicago, IL 60603-2802

850 East Madison Street
 Springfield, IL 62702-5603

Office Hours: M - F 8:30 AM to 5 PM

Ongoing Corporate Formalities

To protect the corporation and its shareholders from “veil piercing”, it is **imperative that the corporation diligently follow corporate formalities throughout the life of the company**. For a small corporation with only one or two shareholders who are also its directors and officers, the formalities may appear to be a matter of form over substance. However, under the corporation laws of the State of Illinois (and most, if not all other states) there is no distinction based on the size of the corporation in terms of compliance with corporate formalities.

Unfortunately, all too many small corporations will fail to follow through after the initial incorporation. This is where the services of a competent business attorney can monitor that the formalities are being followed or, even better yet, take the initiative to schedule the meetings of shareholders and the Board of Directors. As indicated earlier in this discussion, the corporation’s by-laws will govern what is required in terms of formal actions on the part of the Board and the officers.

The minimum requirements for an Illinois corporation will consist of:

- **Filing of the Corporation Annual Report:** Prior to the annual anniversary date of incorporation, the Secretary of State mails a preprinted blank “Corporate Annual Report” to the registered agent of the corporation. It is to be completed and returned to the Secretary of State along with the required corporate Franchise Tax.

There is the misconception that all a corporation has to do is file the form and pay the fee annually, and they have met corporate formalities. What this does is keep the corporation in good standing on the Secretary of State’s database.

- **Annual meeting of shareholders:** The corporation’s by-laws will specify when the annual meeting is to be held. It is possible to conduct a meeting by tele-communication if all of the shareholders (there will be a minimum required for a quorum) cannot be physically present. The agenda will include election of directors to serve until the next annual meeting. There needs to be written minutes of the meeting signed by the corporate secretary. The original of the minutes are filed and maintained with the corporation’s records.
- **Annual meeting of the Board of Directors:** The corporation’s by-laws also specify that there is to be an annual meeting of the Board of Directors. For small, closely held corporations, this meeting usually is scheduled following the adjournment of the shareholders’ meeting. The by-laws will specify the actions to be taken by the Board at its annual meeting. Minimally, this will include appointment of corporate officers for the next year and setting of officer compensation. As with the shareholders’ meeting, there needs to be written minutes certified by the corporate secretary. The original minutes are filed and maintained with the corporation’s records.
- **Actions by the Board of Directors between regular scheduled meetings:** Most by-laws will provide an alternative means for the directors to take required action on items requiring their approval without having to convene a formal meeting. This is known as unanimous consent resolutions where the specified action is documented and signed by the individual directors and certified by the corporate secretary. The originals of all unanimous consent resolutions are filed and maintained with the corporation’s records.

Delaware Incorporation? Occasionally, a client will ask whether they should incorporate in Delaware or the state where their business is located. This is a question that is best left to the client’s legal counsel.

At one time, Delaware had the most favorable corporation laws. However, with the nationwide adoption of either the Model Business Corporation Act or the Revised Model Business Corporation Act, it is our understanding that this advantage has been diluted. Delaware tends to be selected by the larger publicly owned corporations whose securities are listed on an exchange (e.g., the NYSE or NASDAQ). Incorporation in Delaware for a non-Delaware based corporation will require it to use a corporate services firm to serve as their Delaware registered agent and then qualify to do business in Illinois as a non-Illinois corporation. (This also applies whenever a state other than Illinois is selected as the state of incorporation, and a resident employee of the corporation is not available to serve as its registered agent in another state.)

Useful IRS publications:

Pub 542, "Corporations"

S Corporations

S corporations are C or taxable corporations that elect to be treated as a small business corporation under the U. S. Internal Revenue Code. S status provides partnership like pass-through income tax treatment of the profit or loss of the corporation to its shareholders in proportion to their stock ownership percentages.

Other than for pass-through tax treatment of corporate profit and losses, S corps are subject to the same legal requirements, state and local tax regulation, organizational steps, and corporate formalities as are C or taxable corporations that were discussed in the prior section of this article.

Important: Effective with the date of incorporation shown on the "Certificate of Incorporation" issued by the Secretary of State, all corporations are C or taxable corps. Until the S election is approved by the IRS, the corporation will remain a C. Therefore, a timely filing of the S election with the IRS (as will be discussed) is important to accomplishing pass-through tax treatment in the first year of the corporation's existence.

The qualifying requirements for an S corp are:

- No more than 100 shareholders. A husband and wife will be counted as one shareholder for the purpose of determining the maximum.
- Eligible shareholders can only be individuals, decedents' estates, and certain prescribed trusts.
- Non-resident aliens (defined as non-U.S. citizens who reside in the U.S. for less than six months during a year) are ineligible to be S corp shareholders. C corporations and limited liability companies (LLCs) also are ineligible to be shareholders of S corps. The LLC form has no similar prohibition against non-resident aliens as owners.
- The S corp must be a domestic corporation organized under the laws of the U.S. or one of its states.
- There can be only one class of stock (although it can be voting and non-voting).
- All shareholders must consent to the S corp election.

The profit or loss of an S corp is passed-through to its shareholders in proportion to their stock ownership percentages. Profit or loss is reported on Form 1120S, "U.S. Income Tax Return for an S Corporation"

and passed-through to the individual shareholders using a Schedule K-1, "Shareholder's Share of Income, Deductions, Credits, etc."

The distributive share of ordinary income or loss from a trade or business is reported on Page 2 of the Schedule E, "Supplemental Income and Loss" attached to the shareholders' U.S. Form 1040 individual income tax return. Depending upon other sources of income subject to withholding, shareholders may have to file quarterly estimated taxes for federal and state in order to avoid underpayment penalties.

Illinois recognizes S corps and generally follows the federal rules. However, a 1.5% replacement tax is levied on the Illinois source taxable earnings of S corps (it is 2.5% for C corps). Special rules that are different than for federal NOLs (net operating losses) apply to S corporations that have Net Loss Deductions in Illinois.

A word about S Corp losses: Because losses can be used to offset other sources of taxable income of individual shareholders, the S corp is subject to the "hobby loss rules" (discussed under Sole Proprietorships) and is also subject to the passive activity loss rules based on meeting certain material participation tests (which will not be covered) and investment at risk rules (also not discussed). In addition, shareholders' ability to claim losses, even where the passive activity and at risk rules are not an issue, will be determined by their income tax basis in the corporation. Basis needs to be tracked continuously for all shareholders by the shareholders' accounting or tax advisors. All of these topics – basis, material participation tests, and investment at risk rules – are complex and beyond the scope of this article.

Filing for S Corp Status: Following assignment of the EIN (Employer Identification Number) by the IRS, the C corp files Form 2553, "Election by a Small Business Corporation" with the IRS on a timely basis. (Currently, this form cannot be filed electronically.) A timely filing means filing with the IRS within 2-1/2 months of the date of incorporation for it to be effective for the first tax year. Where there is a short tax year (less than 12 months), the form must be filed within 2-1/2 months of the start of the corporation's first tax year. This situation commonly arises with fourth quarter incorporations.

Advantages of S Corps

- **Limited liability for shareholders:** Same as for C corps provided corporate formalities are followed.
- **Unlimited corporate life:** Same as for a C corp. Shareholder interests can be transferable without terminating the business.
- **No double taxation of corporate income:** The profit and loss of an S corp pass-through to its shareholders similar to that of a partnership. Currently, the only tax levied at the legal entity level is the 1.5% Illinois replacement tax.
- **Flexible compensation of shareholders:** Unlike partnerships, shareholders are not subject to the self-employment tax on their proportional share of the earnings of the S corp that are passed through to them. Rather, those who actively participate in the business of the corporation are common law W-2 employees of the corporation. They are required to receive reasonable compensation for their services. A portion of their compensation can be in the form of tax free dividend distributions (which are returns of capital that reduce their basis for federal income taxes). These dividend distributions are not subject to FICA. (See following additional comments section of this article.)

Disadvantages of S Corps

- **No special income and deduction allocations:** The S corp tax rules prohibit distribution of income and deductions that vary from stock ownership percentages.

For example, the single class of stock requirement prevents the use of preferred stock to accomplish flexible income allocations.

Caution: The single class of stock requirement will limit the valuation of S corporation shareholder stock for the purpose of shareholder buy-sell agreements. Special rules apply to family corporations. Clients should seek the services of competent legal and tax counsel when drafting and negotiating S corp shareholder agreements.

- **Limitations on eligible shareholders:** Prohibited shareholders include non-resident aliens, partnerships and LLCs, C corps, many types of trusts, and individual IRAs. This can restrict the sale or merger of an S corp.
- **Carryover of Certain C corp tax attributes:** When an S corp was previously a C corp, there are certain tax attributes that carryover to the S corp at the legal entity level. This is the strongest argument for filing the Form 2553 on a timely basis in the first year for S corps who never were C corps. (Discussion of these tax attributes is beyond the scope of this article.)

Additional Comments about S Corps

Shareholder loans: As a general rule, small corporations often will be capitalized for \$1,000. Minimum capitalization of \$1,000 may or may not be adequate. It should be pointed out that inadequate capitalization can be potential grounds for a judicial decision to allow a corporate piercing. This is in addition to failure to follow corporate formalities (which we have already discussed), co-mingling of personal and corporate funds, and fraud as common grounds for piercing the corporate veil. Clients are advised to consult with their business legal advisor in determining the appropriate capitalization for their corporation (whether it be a C or an S).

Unless the corporation already has an established revenue stream (from its origins as a sole proprietorship, for example), there will be a need for a source of working capital to sustain the corporation through its start-up phase (which can typically last the first 18 to 24 months). Usually, the source of working capital will be one or more or all of the shareholders. There are two ways by which the shareholders can fund the corporation: (1) subscription to additional shares of stock or (2) loans to the corporation.

Since, hopefully, the needs for start-up phase working capital will not be permanent, subscription to additional shares will not be the best way to go. Shareholder loans will be a better funding vehicle for this purpose. However, due to the one class of stock requirement for an S corp, shareholder loans must be structured to strictly comply with the Internal Revenue Code straight debt "safe harbor" guidelines:

- The debt must be in writing and must constitute an unconditional promise by the borrower to pay a sum certain on a specified date or on demand.
- The debt must require the payment of interest at a rate and on specified payment dates that are not contingent on profits or the borrower's discretion.
- The debt cannot be convertible into stock.
- The creditor must be an individual (other than a non-resident alien, an estate, or a qualified trust) or must be a person actively and regularly engaged in the business of lending money.

Failure to structure S corp shareholder loans in accordance with the above guidelines risks the IRS recharacterizing them as a second class of securities, which can result in terminating the S corp election. Termination of the election reverts the corporation to a taxable or C corp.

In addition, the typical corporation by-laws require that the Board of Directors pre-approve all corporate indebtedness. Therefore, it is important that there be a written board resolution dated prior to the effective date of the shareholder loan evidencing this approval. Pre-approving shareholder loans is frequently an agenda item for the initial Board meeting for newly formed corporations.

Shareholder Compensation: Mentioned, as one of the advantages of an S corp is the fact that shareholder compensation is not self-employment income, which would subject the shareholder's proportional share of the corporation's earnings to the 15.3% self-employment tax. However, taking no compensation in years that the corporation is profitable is likely to run afoul of the IRS. In a landmark case known as "Radtke", the U.S. Supreme Court ruled that shareholder-employees are required to take reasonable salary from an S corp, allowing the balance of their compensation to be distributed free of FICA and unemployment taxes. The problem is that there are no guidelines defining what the word "reasonable" translates into in terms of compensation for shareholder-officers/employees. S corp shareholders should consult their tax advisors in the establishment of compensation for corporate officers and other employees who are shareholders.

Shareholder Agreements: As with partnerships and C corps where there will be more than one shareholder, the shareholders are well advised to negotiate a shareholder agreement prior to the act of incorporation.

Limited Liability Company (LLCs)

The limited liability company form of business organization is a relatively recent development in the U.S. Similar types of organizations have long operated in many European countries and South America. The LLC form was introduced in the U.S. to take advantage of the limited liability protection of corporations and the pass-through tax treatment of partnerships. Also, the LLC does not suffer the limitations of S corps in terms of number and type of eligible shareholders. With adoption of LLC statutory law in all of the states, the LLC has, in effect, become an alternative to the S corp.

An Illinois LLC can be organized either as a single or multiple member legal entity. In LLCs, the owners are referred to as "members" as opposed to shareholders for corporations. The organizing members file Form LLC-5.5, "Articles of Organization" with the Illinois Secretary of State. A copy of the Certificate of Organization issued by the Secretary of State is filed with the County Recorder of Deeds where the registered agent resides (same as with corporations). See the Corporation section (page 10) for telephone numbers and addresses for the county recorders in the Chicago metro area.

A separate Operating Agreement will be negotiated between the members. One or more of the members may be designated to be the manager of the LLC. All LLCs must have a designated manager, who does not necessarily have to be a member.

LLCs can be subject to veil piercing the same as with corporations and for all of the same reasons. Corporate formalities will either be defined by the state LLC statutes, the parallel corporation statutes, or be left to judicial decision. Because of the newness of the LLC form, clients who organize as LLCs are well advised to work closely with their legal counsel in the administration of the affairs of the LLC as well as when establishing a new LLC.

Caution: Contracting involving the LLC should be undertaken only after the organization effective date shown on the Certificate of Organization that is issued by the Illinois Secretary of State.

From a tax standpoint, single member LLCs will be taxed as a sole proprietorship, with the income and expenses being reported on Schedule C to the 1040. In the case of multiple member LLCs, the default option will be a partnership, with the income or loss being reported on the Form 1065 return with member allocations reported on the Schedule K-1s. The "check-the-box" regulations provide flexibility as to how a multiple member LLC can elect to be taxed. Partnership taxation is the default option, unless another

entity form is selected by completing Form 8832, "Entity Classification Election" that is attached to the Form 1065 return.

The profit of the LLC will be subject to the 15.3% self-employment tax, the same as with the sole proprietorship and partnership forms. Hobby loss rules and estimated tax payment requirements apply as they do with any of the pass-through entities.

Illinois levies a 1.5% replacement tax on the Illinois source income of LLCs.

Advantages of LLCs

- **Limited liability of members:** Member personal liability is limited to their investment in the LLC, with the same caveat about following corporate formalities as with corporations.
- **Special income and deduction allocations:** Same as with general partnerships. This is in contrast to S corps where no special allocations are allowed.
- **Ownership restrictions:** None in terms of number of members or class of members. Non-resident aliens are eligible to be members of LLCs.

Disadvantages of LLCs

- **Less flexibility for member compensation:** Unlike S corps where shareholders who work in the business can split their compensation between W-2 salary subject to FICA and unemployment taxes and tax free returns of capital in the form of dividend distributions, LLC members are self-employed. Their share of the earnings of the LLCs (and any guaranteed partnership payments) are subject to the 15.3% SE tax.
- **Legal uncertainties:** Because LLCs are still a relatively new business form in the U.S., there is not the volume of case decisions that can be relied upon by courts and legal counsel in trying to determine an outcome in a commercial dispute.

This issue is one that should be evaluated in consultation with your legal counsel in deciding the choice of legal entity for your business.

- **Higher administrative cost:** Secretary of State organizational filing and annual fees are higher in Illinois than they are for the typical small corporation. In addition, the complexity of the partnership tax rules can result in higher accounting and tax advice and return preparation fees for multiple member LLCs versus the typical S corp.

Which is better – S corps or LLCs?

The answer to the question is going to depend upon the individual facts and circumstances for each situation. Here, it is important that advice and counsel of experienced legal, accounting, and tax professionals be sought before making any decision about which legal entity form best meets the needs and tax requirements of the owners. However, there are some very general and broad guidelines that may be helpful to the reader in thinking about and framing questions pertaining to this issue:

- You, as the owner, will have already made the decision to organize as a corporation or an LLC rather than to start out as a sole proprietorship. Or, you are an existing unincorporated business who has concluded that it is now time to "incorporate". (Refer to the discussion at the outset of this section.)

- If you plan to have one or more financially “deep pocketed” investors provide the “lions’ share” of the capital needed in the business and where special income distributions are either required or a desired feature, then the LLC form would best meet your needs. As previously discussed in this article, under U.S. partnership tax law, partnership income and expenses can be distributed differently than ownership interests as long as there is a demonstrated economic reason for doing so. Special allocations are not permitted under S corp tax rules and regulations.
- If one or more of the owners of your business is a non-resident alien (i.e., a non-U.S. citizen who resides in the U.S. for less than six months out of the year), then the LLC is the preferred choice, since non-resident aliens are ineligible to be S corp shareholders.
- If your principal business will be ownership of real estate, then the LLC seems to have become the preferred legal entity form. It is quite common for one or more of the shareholders of either a C or an S corp to hold legal title to the building where the corporation operates rather than having the corporation own it. These shareholders will organize as an LLC to hold legal title to the property. In these types of situations, you should seek expert legal, accounting, and tax advice in the proper structuring of such entities.
- * Absent the foregoing reasons, the S corp tends to be a good fit for most small business enterprises who want to have limited liability protection for their owners and pass-through income tax treatment, coupled with flexibility in the way shareholder-officer/employees are compensated.

Additional Considerations

There remain a couple of subjects that directly impact both corporations and LLCs.

Assumed Names: As with the sole proprietorship, incorporated entities that operate using a trade name are subject to the provisions of the Illinois Assumed Name Act. This can occur, for example, when a brand name becomes the name by which a business is best known. In such cases, it is required to file the following forms with the Illinois Secretary of State:

- **For Corporations:** Form BCA-4.15/4.20, “Application to Adopt, Change or Cancel an Assumed Corporate Name”. The filing is renewable every five years.
- **For Limited Liability Companies:** Form LLC-1.20, “Illinois Limited Company Act, Application to Adopt, Change, Cancel or Renew an Assumed Name”. The filing is effective for five years.

A copy of the approved filing returned by the Secretary of State is to be filed with the County Recorder of Deeds for the county where the corporation’s or LLC’s registered agent is located.

More information about assumed name filing requirements and process can be obtained from the Illinois Secretary of State’s web site, www.cyber/driveillinois.com or by contacting the Business Services area:

501 South Second Street
Room 328, Howlett Building
Springfield, IL 62756
(217) 782-6961
Hours: 8 A.M. - 5 P.M. Mon-Fri

69 W. Washington
Suite 1240
Chicago, IL 60602
(312) 793-3380
Hours: 8 A.M.-5 P.M. Mon-Fri

Operating in Multiple States

Corporations and limited liability companies (LLCs) are legal entities created under statutory law. As such, they are authorized to do business only in the state of their incorporation or organization. When a corporation or an LLC expands beyond its home state, it may need to register to do business as an out-of-state corporation or LLC. What constitutes “doing business” in any given state is determined by the provisions of that particular state’s corporation and LLC statutes and judicial decisions. Advice of legal counsel should be sought if your corporation or LLC will be expanding beyond the borders of Illinois.

There are also tax and accounting considerations that need to be addressed in multi-state operations. These issues need to be discussed with your accounting and tax advisor(s).

If your corporation or LLC is currently operating using a trade name, or plans to do so if you expand beyond Illinois, it probably will be necessary to register the trade name under the other state’s equivalent of the Illinois Assumed Name Act.

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The foregoing discussion and references to materials and information sources are not intended to constitute legal, accounting, or tax advice. In view of the important legal, tax, and business planning issues involved with respect to the formation and operation of a business organization, the reader of these materials is strongly advised to consult with a business attorney and certified public accountant with respect to obtaining appropriate advice on such matters.