



Illinois Business Entities: A Primer

Entrepreneurs who develop great ideas that lead to business opportunities must not only be concerned with the operations, sales, and marketing necessary to bring their product/service to market, they must also consider the legal structure under which their company will operate. Pursuant to the Illinois Business Corporation Act, businesses can be formed in various ways. The form the entity takes determines many things, including how it will be taxed, where liability within the entity falls, and who may act on behalf of the entity. When starting a business, it is important for entrepreneurs to understand the differences between each business structure in order to properly determine which type of entity best suits their needs. The following is a brief synopsis of entities authorized by the Illinois statute.

Sole proprietorship (SP)

A sole proprietorship is the simplest, quickest and cheapest way to establish a business. No forms need be filed with the state and no fees need be paid. A business license or permit may, however, be required. Additionally, the business must file a d/b/a ("doing business as") form with the state if the owner wishes to operate under a name different than his/her exact legal name. A sole proprietorship is an individually owned and operated business where the proprietor is the one and only owner and decision maker for the business. From a legal standpoint, the entity is not separate from the owner and, as a result, profits and losses from the sole proprietorship are reported and taxed on the owner's personal tax return.

The simplicity of setting up a sole proprietorship must be weighed against the potential pitfalls, primarily the unlimited personal liability the owner assumes, meaning the owner is responsible for all business debts and lawsuits filed against the business. While insurance may reduce some of the risk inherent in a sole proprietorship, it is generally insufficient to cover all the potential liabilities that may arise.

General Partnership (GP)

A General Partnership is akin to a sole proprietorship, but it involves two people rather than one. By default, the partners share management and operational control of the entity and also share equally in the profits/losses of the company. A partnership agreement may, however, establish different amounts of control and/or payments among the partners. While a General Partnership may be established without any formal filing, it is highly recommended that the partners have an agreement in place which details their rights and duties to each other.

Similar to a sole proprietorship, taxation occurs at the personal level. Each partner is taxed on their income tax return, based on his/her ownership percentage and the amount of income they receive. While not directly taxed, partnerships are required to file tax returns for informational purposes. Also like a sole proprietorship, partners in a General Partnership are subject to unlimited personal liability. Each partner is responsible in full for the business's debts, any lawsuits filed against the business, and torts committed by themselves, their co-partners,

and their employees. Again, insurance can reduce some, but not all of the risk involved here. Additionally, partners are jointly and severally liable for the company's debts, meaning that a creditor may go after one partner for the full debt of the company. There is no requirement for a creditor to obtain equal judgments against all partners.

Limited Partnership (LP)

A limited partnership is a partnership in which there are one or more "general partners" as well as one or more "limited partners." Under this structure, the limited partners have limited liability (they may lose their investment in the venture, but are not liable for debts of the company). In return for this limited liability, limited partners can have no management authority. In effect, a limited partner is simply an investor in the business and if a limited partner does assert any management control, he will lose his limited liability status and revert to a general partner. The managers of this type of entity are the general partners, whose rights and duties are the same as those described in the general partnership section above. Limited partnerships are required to file documentation with the Secretary of State to establish the entity and the company is taxed as a partnership.

Limited Liability Company (LLC)

A limited liability company is an association whose characteristics are a combination of those of a corporation and a partnership. Unlike a partnership, an LLC is a separate legal entity from its owners. The owners are called members and have limited liability in that they are not liable for anything greater than their personal investment in the company. Members are not personally liable for the torts other members commit or any debts or obligations of the LLC.

Limited liability companies may be member-managed or manager-managed. The form of control is set forth in Articles of Organization which must be filed with the Illinois Secretary of State to establish the company. No further documentation is required to form an LLC, but it is advisable to have an operating agreement, which provides details on the management and operations of the company. In a member-managed LLC, one or more of the owners will run the company. In a manager-managed LLC, the members appoint managers who will run the day-to-day operations of the company.

An additional advantage of an LLC is the flexibility it provides regarding taxation. Members generally elect "pass through" tax treatment (akin to a sole proprietor), thus eliminating any potential "double taxation" problems that corporations encounter. Members can, however, choose to be taxed as a corporation in situations where that would be beneficial.

Corporations

A corporation is a business entity that is separate from its owners (shareholders) and, similar to an LLC, offers its owners limited liability. Unlike an LLC, however, a corporation must follow specific rules of operation, or there may be a "piercing of the corporate veil," meaning the owners may become liable for more than their initial investment in the company. Corporations follow two basic structures: C Corporations and S Corporations.

C Corporation

A C Corporation is the most common type of corporation. C Corporations are generally privately or closely held, meaning their stock is not publicly traded in a market. However, the mega-companies people come into contact with every day are usually publicly traded C Corporations. Shareholders of smaller C Corporations often also act as directors and officers of the company, whereas larger C Corporations generally have a board of directors and officers distinct from their shareholders.

Formation and operation of a C Corporation is the most complex of all the business entities, with particular rules and formalities that must be followed. To initiate the company, a promoter must file appropriate documents with the Illinois Secretary of State, which include the articles of incorporation. Next, directors must be appointed and bylaws must be created. Finally, all necessary permits and licenses required for operating the business must be obtained.

Once formed, the corporation must adhere to various formalities, including holding regular meetings of the board of directors and shareholders. Minutes of meetings must be kept and corporate action must be properly documented. Finally, an issue that may be overplayed at times, but must be taken into account is the “double taxation” problem C Corporations face. Simply put, double taxation means that corporate income is subject to income tax and the shareholders are also subject to income tax on dividends they are paid from the corporation.

S Corporation

S Corporations differ from C Corporations in two primary ways. First, S Corporations are flow through entities (similar to LLCs) and are not subject to double taxation as discussed above. The S Corporation’s income is reported on each shareholders personal income taxes, based on their percentage of shares owned. In return for this benefit, S Corporations must adhere to limitations not placed on C Corporations, most notable of which involves the number and types of shareholders allowed. Otherwise, S Corporations must be governed in a manner similar to C Corporations.

Conclusion

This article is intended to provide the reader with an overview of the means of business formation in Illinois. The information provided is accurate, but due to the length, does not discuss all the matters related to each form of business entity. Complex issues related to management, ownership, liability and taxation, among others, will often arise and should be directed to a business attorney.