



ATTORNEY
DEMITRUS
EVANS

LEGAL STRUCTURE

HOW TO CHOOSE THE CORRECT
STRUCTURE FOR YOUR
BUSINESS

"A **must read** for **entrepreneurs** starting a business."
-Kimberly Adams, Founder of Grace2be

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A NOTE ON THIS PUBLICATION

Dear Reader,

This guide is meant to simplify the process of selecting the proper business structure. The real and only important question is: which is best for your company? To decide this, you may have to explore the entire gamut of structures. This book will empower you to do that. I look forward to the expansion of your business.

Sincerely,

Attorney Demitrus Evans, JD LL.M.



LEGAL STRUCTURE

HOW TO CHOOSE THE CORRECT STRUCTURE FOR YOUR BUSINESS

INTRODUCTION

After deciding what type of business you want to start, you should next decide what business structure it should be.

One of the main questions to consider is,

“HOW FORMAL SHOULD YOUR BUSINESS BE?”

There is a clear difference between a business and a hobby. A formal business has clear structure. For instance a corporation will have bylaws, a board of directors, shares and must operate within the regulations of the state, formal. Formal businesses in the United States are also registered with the State government. Hobbies, however, are informal, and do not necessarily need filing. Collecting money for pies, that you bake in your home, may be a donation for a fundraiser. There is little formality with this type of businesses, and they are not registered with the government although you may still have liability.

Simply making the decision to do one or the other is legal structuring. Not making a decision is a decision in itself. The important factors in this process include the way the business is taxed, managed, owned, raises capital, and how much liability or risks you want to take on and the amount of money and time you want to put into the company initially. The initial organizing questions should be decided after meeting with a business lawyer. Some people will try to do it on their own. I am not saying this is automatically a mistake. However, more than once I have had to restructure a company, because the organizers trusted online sites to form a legal structure without the proper questions for the long term being answered. It cost them money and time to redo it.

INTRODUCTION

This legal structuring process is first done at the state level with the Secretary of State. However, when it comes to how you or the entity will be taxed by the IRS, in the United States, the structure may elect to be taxed as a different type of entity. For instance, you may form an LLC in the State of Illinois, but be taxed as a corporation with the Department of Treasury. If you decide that it is best for you not to register the company then you will operate as a Sole Proprietor or a Partnership, if there is an additional person.

I hope this book is of great help to you, and that it aides you in selecting the best structure for your business.



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**SOLE
PROPRIETORSHIP**

SOLE PROPRIETORSHIP

The Sole Proprietorship is the simplest structure. That is because the entire entity is you. You take all the responsibilities and risks, you put in all the capital, keep all the minutes if you want them. You do it all, the business is not you separate from you. This is why it's difficult to sell the business, because you cannot just sell you.

You may have an assumed name or have a d/b/a "Doing Business As" but the business is still you. Many times it starts off as hobbies and turn into businesses. For example, if you start selling your pies from your home then you are operating as a Sole Proprietor. You can do that by accident or make a choice to operate.

As a Sole Proprietor, you are not registered with the government agency, which makes it easy to form. The money that you earn will be reported on your Schedule E or EZ and SE Self Employment Tax. However the disadvantage is that you operate to the extent of all of your personal assets. You can operate as your name or another name. You may still need a license to do the business, but if you decide to sell or bequeath the business you will find it hard to sell something that is really yours.



PARTNERSHIPS

There are several types of Partnerships, but for this discussion I will introduce two (2) types only: **General Partnerships** and **Limited Liability Partnerships**. **General Partnerships** are two or more people coming together in business, contributing either **money, skills, labor,** or all of those. Each person shares in profits and losses.

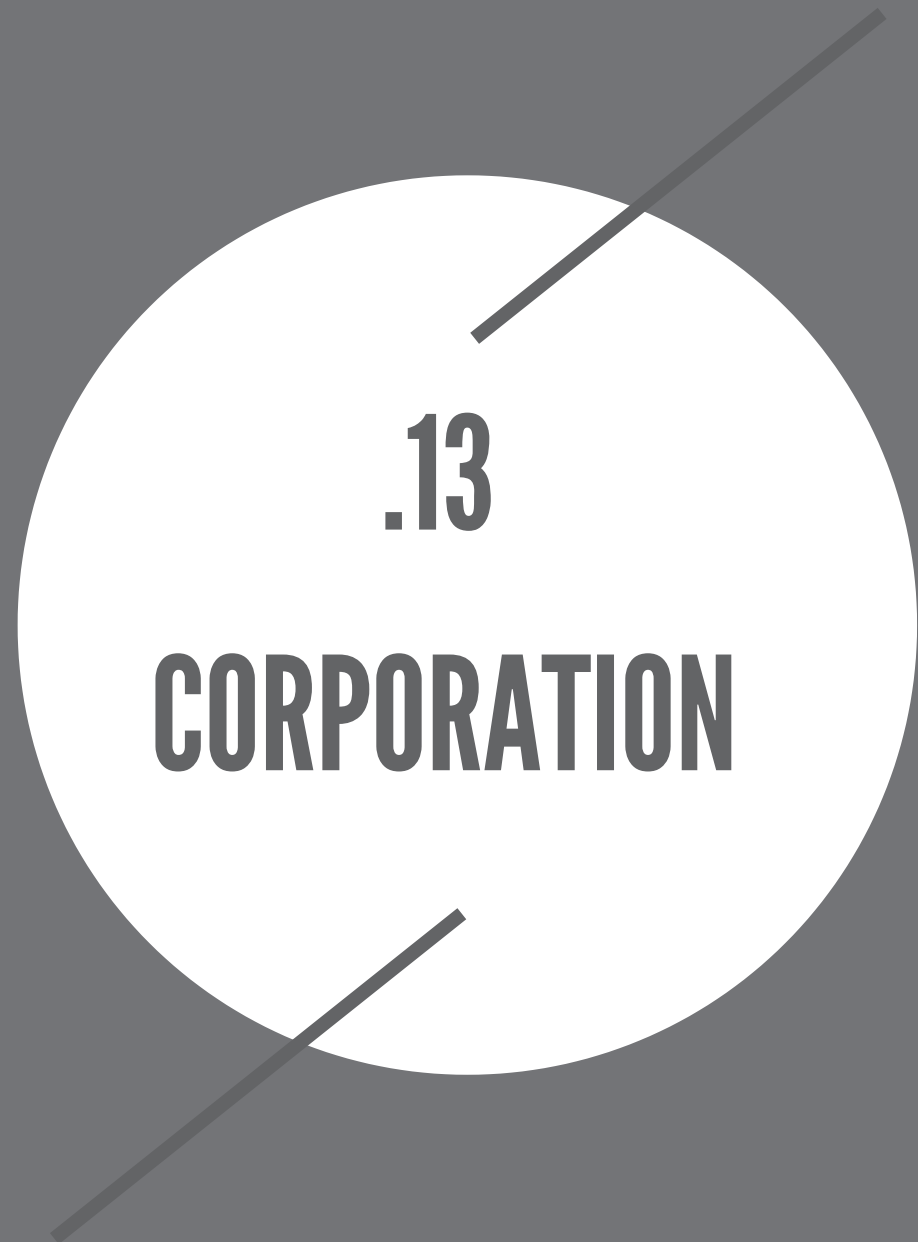
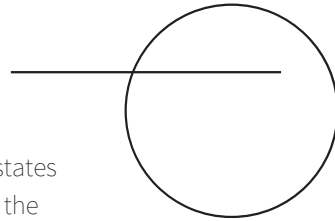
They can be formed **orally, in writing** or **implied** by a court from **parties' conduct**, such as pooling capital resources, sharing management duties and/or sharing business profits or losses. It is recommended that you have a written **Partnership Agreement** that spells out each partner's **rights and duties**.

Why does this matter?

It will help avoid future litigation between partners. Several states mandate the filing of a certificate of partnership to evidence the existence of a general partnership.

Just like the **Sole Proprietorship**, there is **no sheltering** of your **personal assets** and the **income** carries over to personal income taxes. The added difference is that now one person can totally bind other people for what they do because you are partners and **impliedly** are **working together**.

Limited Partnerships however must be registered. There should be one general partner and others as the "Limited Partner" are **sheltered** up to the amount that they **contribute** to the company.



CORPORATIONS

Corporations are one of the **oldest** registered legal structures. They are recognized all over the world, although in certain countries they are called “companies.”

There are **three (3)** types that I will discuss here:

- General Corporations,
- S Corporations and
- Benefit or B Corporations.

The General Corporation is the most common corporate structure. You may also hear people call it C-Corporation.

Its owners are called **stockholders/shareholders**, because they are provided a document called a **stock certificate** as **proof** that they are owners.

When the corporation makes a profit, it then can **declare** a **dividend** that the **stockholders** will receive. The **stockholders numbers** can be **unlimited** and the stocks are **protected** from the creditors of the business. A stockholder normally has **no personal liability** and is limited to the amount of their investment in the corporation only.

Another **benefit** of having this entity is that you can **raise capital** in a **private offering**. It can also transact business globally by acquiring other businesses, or eventually becoming publicly traded.

CORPORATIONS

There are, however, several corporate formalities which must be followed. For example, Corporations must hold regularly scheduled meetings, document decisions through corporate minutes, conduct banking through a separate corporate bank account, and file a corporate tax return in order to stay in compliance with state statutory requirements. If corporations fail to do, the shareholders may be subjected to **liability**. However, shareholders are normally only subjected to the amount which has been invested.

The worst case scenario is that the corporation is not following formalities and the corporate veil is pierced, resulting that the shareholders are personally liable. This is normally decided by a court during the litigation. Corporations are however a great way to raise money; because of the sale of stocks which can be sold to individuals, businesses, even other corporations, and aliens.

There are of course, **disadvantages**. One disadvantage is that a Corporation is subject to **double taxation**. This happens because corporation pay taxes on the **earned profit** and once the corporation use the earned profit to pay the shareholders as dividends, the shareholders pay taxes on that income **again**. Double-taxation can be **minimized**, however, through **proper planning**.

Besides being the owners, shareholders have the **responsibility** of electing the **Board of Directors** and of **voting** on matters of **major significance** to the company, like whether to **amend** the articles of incorporation and bylaws, to **approve** the sale of all or substantially all of the corporate assets, to approve mergers and to **reorganize** or dissolve the corporation.

CORPORATIONS

Directors generally set policy for the corporation and are responsible for the overall management, and make major financial decisions such as: authorizing the issuance of stock, deciding if, when, and the amount of dividends to be issued to shareholders, electing the corporate officers and hiring key management and overseeing salary amounts along with loans, real estate sales and leases.

The corporate structure has Officers like President, Vice President, Secretary and Treasurer, to handle the day-to-day operations of the corporation.

They may, if required, hire a Chief Counsel, Marketing Manager, Operations Manager, or any other designated title.

S CORPORATIONS

Another well known, but largely misunderstood structure is the S Corporation.

An S Corporation is **not** really a **different** type of corporation. It is a special **tax designation** applied for and granted by the IRS to corporations that have **already been** formed. Many entrepreneurs and small business owners are partial to the S Corporation because it combines many of the advantages of a sole proprietorship, partnership and the corporate forms of business structure.

S Corporations have the same basic advantages and disadvantages of general or close corporation with the added benefit of the S Corporation's special tax provisions. When a standard corporation (general, close or professional) makes a profit, it pays a **federal corporate income tax** on the profit. If the company declares a dividend, the shareholders must report the dividend as personal income and pay more taxes. This is the double taxation we discussed in the General Corporation Section.

S Corporations avoid this "**double taxation**" because all income or loss is **reported** only **once** on the personal tax returns of the shareholders. However, like standard corporations (and unlike some partnerships), the S Corporation **shareholders** are **exempt** from **personal liability** for business debt.

S CORPORATIONS

To elect S Corporation status, your corporation must meet specific guidelines.

S CORPORATION RESTRICTIONS WORTH NOTING:

- The maximum number of shareholders is now 100.
- S Corps may be owned by individuals, estates, business trusts if all beneficiaries of the trust are individuals or estates.
- Charitable organizations may hold limited interests. Interests in the trust must be acquired by gift or bequest -- not by purchase.
- S Corporations may own 80 percent or more of the stock of a regular C corporation, which may elect to file a consolidated return with other affiliated regular C corporations.
- The S Corporation itself may not join in that election.
- An S Corporation is now allowed to own a "qualified subchapter S subsidiary."
- In addition, The parent S Corporation must own 100 percent of the stock of the subsidiary.

S CORPORATIONS

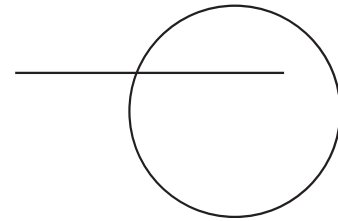
- Qualified retirement plans or Section 501(c) (3) charitable organizations may now be shareholders in S Corporations.
- All S Corporations must have shareholders who are citizens or residents of the United States. Nonresident aliens cannot be shareholders.
- May only issue one class of stock.
- No more than 25 percent of the gross corporate income may be derived from passive income.
- Not all domestic general business corporations are eligible for S Corporation status.

These exclusions include:

- A financial institution that is a bank;
- An insurance company taxed under Subchapter L;
- A Domestic International Sales Corporation (DISC); or
- Certain affiliated groups of corporations.

Keep This In Mind

- These lists of qualifying S Corporation aspects are not all-inclusive.
- In addition, there are specific circumstances in which an S Corporation may owe income tax.

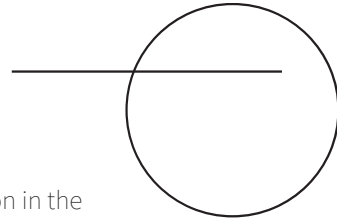


S CORPORATIONS

Keep This In Mind

To establish an S Corporation, you must form a corporation in the state of your choice, obtain the formal consent of the corporation's shareholders and then complete IRS Form 2553, Election by a Small Business Corporation, before the 15th day of the 3rd month of the 1st incorporation year, to be deemed as timely filing.

Every year, you need to file additional tax document, Form 1120S, U.S. Income Tax Return for an S Corporation.



BENEFIT CORPORATIONS

The newest corporate structure is called a **Benefit** or **B Corporation**. Mainly this corporation shows to the public that your corporation is socially conscious and that you are **not only trying to make a profit for the stockholders**, but you are working for the greater good of society.

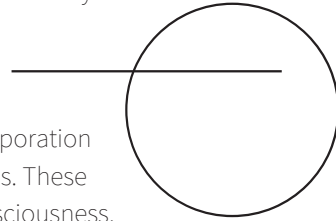
Keep This In Mind

There is specific language that goes into the articles of Incorporation for your designated state and some states require extra steps. These are great to form if your business model requires social consciousness.

As you can see **taxes** play a major role in choosing a legal structure. However, when you are **taxed** at the **federal level**, the structure does not really matter as you still must **elect** how you want the organization to be treated. For tax purposes with the **federal government** there is the corporation, partnership, or a pass-through business.

The **Pass-through businesses** are those in which the profits and losses of the business pass through to the owners or shareholders. In other words, **the business income is considered as the owner's or shareholder's income**, and the owner/shareholder pays the tax on his or her personal tax return. Limited liability Companies, like partnerships, are pass-through entities, unless the owners file some forms with IRS .

To be treated as a **partnership** for federal tax purposes, companies are required to file the same federal tax forms as partnerships and take advantage of the same benefits.



.22 LIMITED LIABILITY COMPANIES

LIMITED LIABILITY COMPANIES

Limited Liability Companies (“LLC”) are sometimes called Limited Liability Corporations; but that is not a legal term. The LLC structure offers the business owner **limited liability** while it is relatively **easy to structure** as compared with the **corporation formalities**. Upfront, however, LLCs can be more **costly to form**.

To begin you have to **file the Articles of Organization** with the Secretary of State. (As opposed to the Articles of Incorporation that are filed when forming a corporation). The **articles of organization** identify the name of the LLC, **business location, members, and duration**, along with other **statutory requirements**. The members of an LLC are the owners. The LLC can be a **Single Member LLC** or a **Multi-Member LLC**.

If you form a single member LLC, you own, manage, and operate your business alone. As a **single-owner LLC**, you can set **your own business strategies** and policies without having to consult or seek approval from others, but you **may lose out on the professional experiences and insights of fellow owners**. A single-member owner **maintains limited liability** for the debts and actions of the company.

LIMITED LIABILITY COMPANIES

For multi-member LLCs, namely there are two or more members, your LLC's operating agreement may be used to structure management roles and decision-making authority in a way that best suits your business needs. It will clarify members' rights and responsibilities. You may decide that all members will manage the LLC or delegate the management and decision-making powers to certain designated members. The operating agreement is the "rule book" for the organization, like the ByLaws for Corporations.

This structure is popular because of the lack of formality of a corporation, management flexibility and flow through taxation. The owner can choose the entity to be taxed as a sole proprietor, partnership or corporation. Form 8832 Entity Classification allows the entity to be taxed as a C Corporation, compared with Form 2553 for S Corporation. Without the submission of these forms, the IRS will treat the entity as a sole proprietorship or a partnership.

The tax consequences to LLC and corporate owners are different. Owners of a corporation may not be paid, but they receive dividends and taxed on that income. Owners of an LLC can be taxed like partners in a partnership; that is, they receive a share of the profits each year, and pay taxes on that share on their personal tax returns.

LIMITED LIABILITY COMPANIES

Owners of an LLC can also pay self-employment tax on their income from the business, while corporate owners who work in the business are considered employees and pay tax on their employment income, along with FICA taxes. As you see, tax structuring for an owner of an LLC, Partnership or corporation is a huge consideration for determining the type of business structure you will form. As previously mentioned: it could also be taxed as an S-Corp if elected.

LLC members are entitled to manage while retaining the limited personal liability of shareholders in a corporation. Normally LLC members are not personally liable for LLC debts or legal liabilities, putting only their financial contributions to their LLC at risk. LLC owners may still be personally liable for their own conduct that harms others, for breaches of their duties owed to their LLC, or personally guaranteed LLC loans. Any business owner should consider appropriate insurance and other liability protection strategies to help shield personal assets and business resources.

You are able to pair up the LLC with other LLC's and be taxed under one umbrella. You can now create complex LLC such as Series LLC and Low Profit LLC called "L3C". Low profit is not to be confused with Non Profit that is named as such because it does not pay taxes or is "Tax Exempt." More details with respect to Series LLC and L3C can be found in other chapters.



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NON PROFIT
CORPORATIONS

NON-PROFIT CORPORATIONS

The Non Profit Corporation, is only tax exempt if the process is fully in compliance with the statutory requirements. The process is lengthy and the amount of time depends on the organization and the organizers. It takes the IRS time to understand the greater good that will be served.

The IRS will allow the business to operate as tax exempt status when the format are complied with the requirement and the company is operating for the greater good of the society with its main purpose, like a company formed to be a charitable organization. It includes colleges, hospitals, churches and other organizations doing work on behalf of the society.

Non-profit doesn't mean "no" profit, it just means that the profit is used for the organization. Also the non-profit is never "owned." It is only organized. So if "ownership" is important to you this may not be the proper structure, unless ownership is less important than tax exemption.

The Non-profit has an additional step after filing with the Secretary of State. The IRS requires an application along with documents including so called the 1023, ByLaws, marketing plans, conflict of interest policies, missions, etc. The IRS uses these materials to determine the true purpose of the Non-profit. Many companies are not granted tax exempt status.

NON-PROFIT CORPORATION

After understanding the simple legal structures, my students often ask,

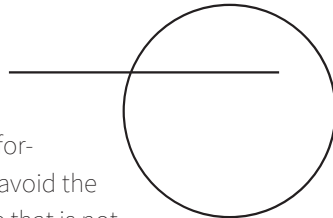
“CAN A FOR-PROFIT OWN A NON-PROFIT, OR VICE VERSA?”

The answer is really yes to both, but the intention behind creating either will be heavily scrutinized. If a for-profit organization creates a non-profit entity, the typical outcome is the creation of a corporate foundation, which is a totally separate and independent from the for-profit company.

The non profit then receives its principal endowment from the parent company. Corporate foundations typically award grants for charitable purposes to tax-exempt organizations and causes that the for-profit company supports. If a non-profit creates a for profit company subsidiary, the subsidiary will not be tax exempt.

Keep This In Mind

Where the non-profit has income that is unrelated to the for-profit it is best to create a for-profit subsidiary in order to avoid the possible risk of the non-profit being as generating income that is not connected to the non-profit for which it could lose its tax exempt status, if the activities were carried out under its tax-exempt status.



PRAISE FOR THIS PUBLICATION

"I received my corporate books and completed my business plan. It's so nice to know that I have the correct legal structure, and I'm thankful to my TEIL family for the work and encouragement."

- Devan'te Hill

"This is a must read for entrepreneurs starting a business."

- Kimberly Adams,
Founder of Grace2Be



Legal Structure Workbook Page

What legal structure would you choose? Give three reasons why.



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