

# Company Structure



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# Common Business Entities



- Sole Proprietorship
- Partnership
- S Corporation
- C Corporation
- Limited Liability Company
- Single Member Limited Liability Company

# Factors to Consider in Selecting an Appropriate Business Entity



- Liability – Limited Liability v. Personal Liability
- Tax Implications
- Complexity of Formation and Management
- Capital – effect on ability to raise capital through angel investment, venture capital, or initial public offering (IPO)
- Credibility in the business world

# Sole Proprietorship



- An individual (or husband and wife team) carrying on a business for profit
- Unlimited personal liability
- Single level of income tax – all income and expense items reported on Schedule C of the owner's 1040
- Relatively simple to start
- If business conducted other than under the name of the sole proprietor, assumed name publication needed
- Managed by the sole proprietor
- Any transfer of the business would be of the underlying assets as opposed to a transfer of shares in the business
- Capital needs – addressed through loan to sole proprietor

# General Partnership



- Association of two or more co-owners carrying on business for profit
- Partners have unlimited personal liability for partnership debts
- Pass through tax treatment (partnership files form 1065 but all income and expense items pass through to individual partners on schedule K-1)
- Relatively easy to start – partnership agreement is typically entered into but is not legally required
- Managed by the partners or as described in the partnership agreement; Problem: any partner can bind the partnership
- Ability to raise capital limited since most investors would prefer to invest in an entity offering limited liability
- LLC is almost always the better choice if partnership tax treatment is the goal

# S Corporation



- ▣ Limited liability for shareholders even if they participate in management
- ▣ Pass through tax treatment under most circumstances but not as complete as for the LLC
- ▣ Formation steps include filing Articles of Incorporation with the Secretary of State, filing sub s election with the IRS, adoption of bylaws, and, usually, adoption of a shareholder (buy-sell) agreement
- ▣ Limitations on the number of shareholders and the type of shareholders limits ability to raise capital
  - ▣ Limit of 100 shareholders
  - ▣ Only one class of stock is allowed so ability to give priority return of capital to investors compromised
  - ▣ Differences in voting rights is allowed
  - ▣ Partnerships and corporations cannot be shareholders
  - ▣ Only citizens or residents of USA can be shareholders
- ▣ Is easier to convert S corp to C corp than it is LLC to C corp in event venture capital is sought

# C Corporation



- ▣ Limited liability for shareholders even if they participate in mgmt
- ▣ Tax at both corporate and shareholder level. This double level tax can be avoided to some extent by payment of reasonable salaries to shareholders in exchange for services actually rendered
- ▣ Formation similar to S corporation except sub S election not filed with IRS
- ▣ Typically required for publicly traded corporations, businesses that require venture capital, or if a broad based stock option program is utilized
- ▣ No limits on type or numbers of shareholders
- ▣ Different classes of stock allowed thus enabling different priority for return of capital
  - ▣ Common Stock
  - ▣ Preferred Stock

# Limited Liability Company



- Combines limited liability provided by a corporation with pass through partnership tax treatment
- LLC files a partnership tax return with all income and expenses being passed through to individual owners of the LLC
- Formation steps include filing articles of organization with the Secretary of State, contributing an appropriate amount of capital, and adopting an operating agreement
- Can be managed by the members or, more often, by managers selected by the members. Can also elect officers
- Self employment tax treatment less favorable than for S corporation
- Offers several advantages over the S corporation:
  - No limitation on the number of members
  - No limitation on who may invest (corporations, partnerships, and non US residents can invest)
  - Treatment of gain on distribution of appreciated property more favorable
  - Different classes of ownership are allowed so there is the flexibility to provide for a priority return of capital to investors

# Single Member Limited Liability Company



- Limited liability for owners makes it a better choice than a sole proprietorship unless cost of formation or maintenance is a controlling factor
- Disregarded entity from an income tax perspective
  - All income and expenses are reported on the sole member's tax return and no income tax return need be filed by the LLC
- Formation process similar to multiple member LLC except that the operating agreement will likely be less complex
- In addition to circumstances where a sole proprietorship would be considered, a single member LLC is often used by a corporation or LLC to insulate the liability associated with a particular line of business

# LLC vs. Corporate Structure



## LLC

Members

Managers  
(optional)

Officers  
(optional)

## Corporation

Shareholders

Board of  
Directors

Officers

# Bylaws and Shareholder Agreements for Corporation



## ■ Bylaws

- Procedures for shareholder and director meetings
- terms of directors and how elected, types officers and officer duties, and indemnification provisions for officers and directors

## ■ Shareholder Agreements

- restrictions on the transfer of ownership (including upon death, disability, or cessation of employment)
- provisions for resolving deadlock among the shareholders
- method of establishing price of shares
- rights to purchase additional shares issued by the corporation (preemptive rights), rights to sell shares if other shares of the corporation are sold (co-sale rights), rights to cause a minority shareholder to sell its interest in the corporation when the majority votes to do so (drag along rights)
- ownership of intellectual property

# LLC Operating Agreements



- Take the place of both the bylaws and shareholder/buy-sell agreement used for a corporation
- Address issues such as type of membership interests, who owns the membership interests, rights and duties of members, whether the LLC is member managed or manager managed, rights and duties of any officers, capital accounts, allocation of profits, transferability, and indemnification of managers, employees and agents

# Piercing the Corporate Veil



- Limited liability associated with a corporation or an LLC can be lost if appropriate formalities are not followed
- Corporation or LLC should be appropriately capitalized upon setup
- Annual meetings of shareholders and directors (or members and managers if an LLC) should be conducted and minutes of those meetings placed in the corporate or LLC book
- Separate financial records and bank accounts should be maintained for corporation or LLC

# Employment Agreements



- Nondisclosure of information/trade secrets
- Noncompetition
- Nonsolicitation of employees and customers
- Assignment of ownership of intellectual property to company (Illinois Employee Patent Act)
- Employee duties
- Compensation
- Term of agreement and ability of parties to terminate

# Using Company Equity to Motivate and Retain Employees



- Incentive Stock Options
- Nonqualified Stock Options
- Restricted Stock
- Phantom Stock

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