

# BUSINESS LAW 101: CHOOSING THE CORRECT LEGAL ENTITY

By: Brian R. Fons, Esq.

Every business owner has to make a decision on the legal organization that the business will take. There are several different types of legal entities to choose from and each one has different liability and tax consequences. Among the different choices are sole proprietorships, S corporations, C corporations, limited liability companies, and partnerships.

## **Sole Proprietorships**

A sole proprietor is simply an individual transacting business. The law makes no distinction between the individual owner and the business. The liability and tax consequences associated with a sole proprietorship stem from this important element. While it is the simplest type of organization, it provides the individual with the least liability protection and the least flexibility come tax time.

The individual operating a sole proprietorship incurs unlimited personal liability for all of the business debts. If the business is liable on a contract, or negligently causes personal or property damage, the individual's personal assets can be used to pay the debt. This could include not only business assets, but also personal investments, automobiles, and any other assets that the owner may have.

Because the law makes no distinction between the individual owner and the business, there are some tax advantages (and disadvantages) to operating as a sole proprietor.

The first advantage is that sole proprietors are not subject to double taxation, which occurs in C corporations. The profits of the business are reported on the individual's tax return only. When a C corporation makes a profit, the corporation declares dividends and pays a tax on that profit. The owners, or shareholders, of the corporation also pay income tax on the income derived from the dividends. This is called double taxation.

The second advantage occurs if the business takes a loss in any given year. Since most start up businesses lose money in the first year, this can be significant. The loss that the business takes can be used to offset any other income that the owner has for that year, including wages, interest, or investment income. If the owner files a joint return with a spouse, the spouse's income can be offset as well.

## **Partnerships**

The law makes no distinction between the partnership business and the partners. Because this structure is much like a sole proprietor, the liability and tax consequences are similar. A partnership occurs when there are two or more partners who share profits of a business. A partnership does not exist when an individual merely pays wages to an employee out of business income. There must be a verbal or written agreement to share profits before a partnership will occur.

Because the partners may be personally liable for the debts incurred by any other partner acting in the scope of the partnership, this is the riskiest form of business. Businesses

operating as partnerships should seriously consider some sort of liability protection, including incorporating the business or insurance.

## **Corporations**

A corporation can have one or more owners. Most states permit one person to be the only owner, director, and officer of the corporation. Massachusetts is one of the few states that require at least two people to be named in the *Articles of Incorporation*.

A corporation transacts business through its directors and officers. Ultimately, decision making is vested in the shareholders of a corporation. The board of directors are elected by the shareholders to act as decision makers. The officers of the corporation make day to day decisions and sign all official documents on behalf of the corporation. Officers are required to act at the will of the board of directors. In small companies in most states, one person can be the shareholder, director and only officer of the corporation. This is often the case for entrepreneurs in their first few years.

The important distinction between a sole proprietor and a corporation is that a corporation is treated as a separate entity apart from its owners. If a business incurs debt beyond its resources, the owners do not incur any liability beyond their capital contribution to the company. Any judgments against a corporation are limited to corporate assets. The individual's personal investments and outside income are protected.

Because they are treated as separate entities, C corporations pay an entity level tax and are possibly subject to double taxation. If a C corporation pays a dividend the actual take home income of the owner may be reduced to less than 50% of the profits, with the majority going to the IRS.

Section 1361 of the Internal Revenue Code allows small businesses to make an election to be an S corporation. Among the requirements to be eligible for S corporation status is that the corporation be owned by 100 or fewer legal permanent residents of the United States. This is the case for most entrepreneurs. An S corporation maintains the identical liability protection that a C corporation enjoys, but does not have to pay the double taxation. S corporations are commonly called *pass-through entities* because the profits *pass through* to the shareholders, without being taxed at the corporate level.

Larger companies, including all publicly traded companies, have more than 100 shareholders, excluding them from eligibility for S corporation status.

The owner of an S corporation can limit the amount of FICA tax it pays by engaging in a widely accepted practice called *wage reduction*. While sole proprietors pay self-employment tax on all earned income, the owner of an S corporation only pays Social Security tax on wages, not dividends. An individual owner/ employee can pay a reduced (but reasonable) wage and declare a FICA-free dividend. For a complete understanding of wage reduction, consult your CPA or attorney. Many entrepreneurs benefit by filing the appropriate forms and making the S-election.

## **Limited Liability Companies**

LLC's are the newest type of business entity. For that reason, the laws surrounding them are uncertain and rapidly changing. Generally, an LLC maintains the limited liability that a corporation enjoys, but is taxed like a partnership. Like an S corporation, an LLC is a *pass-through entity*.

LLC's do not have the strict ownership requirements that exist for S corporations. There is no limit on the number or the character of owners of an LLC. An LLC can be owned by any combination of U.S. or non-U.S. residents, corporations, and other LLC's. LLC's are very popular in real estate transactions because of the special rules regarding real estate taxation. As they become more popular, they will be replacing limited partnerships and other similar entities. Also, most states have adopted statutes that provide for Professional LLC's, for law firms, accounting firms and other professions where there is a licensing requirement.

## **Conclusion**

Choosing a business entity can have very serious tax and liability consequences and the most important thing is that the owner make an informed decision. Every business is different and what may be good for one company may not be for another. You may want to consult a professional in this field if you are unsure of what is best for you.

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# Operating a Sole Proprietorship in Illinois

Many individuals who start a business are unsure about the legal requirements they must go through before starting. The first decision the entrepreneurs must make is the type of legal entity that the business will take. For a complete discussion of the differences between legal entities, please read “**Business Law 101: choosing a legal entity**”, by **Brian R. Fons**. While it is an important decision, the type of entity chosen can always be changed from year to year. If you change accountants or lawyers and decide you would like to incorporate or un-incorporate your business, that can be done.

If you choose to operate as a sole proprietorship, there are certain filings that must be done at the state, county, and federal levels. It is important to follow the statutes governing the operation of a sole proprietorship to avoid penalties and delays in operating your business.

## What’s in a Name?

The first thing all businesses will do is choose a name. It is the identity of the business that will ultimately attract the customer or client. The name should readily identify the product or service offered. For example, “Jack’s Auto and Brake Service” would be a good name for a auto repair shop, but not for a candy store. This is an obvious example but there are not so clear situations that you may have to deal with.

If you operate your business as anything other than your exact name, you are required to file an **assumed name** with the **County Clerk’s office**. The appropriate forms can be obtained directly through the county. Most sole proprietors accomplish this relatively simple feat. The filing fee is only \$10 in Cook County. The information required is your name and address and the name under which you want to transact your business.

The next step is where we lose many otherwise law abiding business owners. After you receive the stamp filed documents back from the county, you have 15 days to have them “published”. Legal and public notices date back to the days of England when everybody wanted to know what everybody else was doing. Nowadays, only mass marketers and very bored people browse through the legal notices section of the paper. You must publish for three consecutive weeks. Any of the papers “of general circulation” is fine. If you really want to have your business in the Chicago Tribune, you can publish in there for \$121 for the three weeks. If you are publishing for the sake of satisfying the statute, choose a less expensive paper like the *Reader*. You will save a few dollars.

After the “publication” you have one more step to go before your are done with the assumed name requirements. The newspaper in which you have published will issue a proof of publication and send it to you after the publication period has been fulfilled. You must take this proof and mail it back to the county within 50 days of the original file date. Upon receiving it, they will send you a “Certificate of Assumed Name”. If one of these important steps or deadlines is missed, you will have to start over from the beginning.

## Trademarks

If your name is very important to you, you may want to register a state or federal trademark. Registering a trademark will help protect your rights if there is ever a fight over who owns the name. A trademark can be a very valuable asset to a company. You can register the mark at the state level if you use the name or logo in Illinois exclusively, or register at the

federal level if you actually use or intend to use the mark in "interstate commerce". The internet is a great way to allege "use" in "interstate commerce" because there are no boundaries over the web. A federal trademark is good in all 50 states. Mailing yourself a letter is not use in interstate commerce, contrary to popular belief.

You will only obtain trademark rights in a certain class or category. For example, if you operate a liquor store under the registered name "TIPSIES" and someone else comes up with the name "TIPSIES" for a sailing cruise ship service, you will probably not have any legal remedy because there is no "likelihood of confusion" between the services rendered. Be careful before you open Coca-Cola Brake Service because the "Federal Anti-dilution Act" will get in your way. The law makes this exception for "famous marks".

### **Notifying Uncle Sam**

After you have decided on a name and are ready to operate your business, you must file with the IRS. If you are going to have any employees, you must file for an Employer Identification Number (EIN). It is also referred to as your "3-6" number because the IRS assigns a prefix of "36" to all businesses located in Illinois. This is just like a social security number for your business. The IRS has assigned the number "SS4" to the form you need to fill out to obtain this number.

### **Your Secretary of State Needs Your Information Too**

Once you have your EIN, the next step is to register with the department of revenue. This form can be obtained by calling the state and asking for it. They will mail it to you the same day. The form is form number NUC-1. Every new business, including sole proprietors, corporations, partnerships, LLC's and others, must prepare and file this form upon starting a business.

You will also have to prepare and file with the Department of Unemployment Insurance if you will be having employees. You will be responsible for withholding taxes for any wages paid out while conducting the business. The form number for this is UI-1. Again, this form can be obtained by calling or writing the appropriate state department.

### **City and County Filings**

Every city will have its own set of rules for filing as well. For example, the City of Chicago, until recently, did not allow home based businesses. Now, if you wish to operate a home based business, you must obtain a permit to do so. This will cost approximately \$150. The penalty for not obtaining a home based business permit is \$200 per day. Enforcement is a big problem for the city and it is unlikely that they will issue a \$60,000 fine if you operate your business without getting a permit. The more likely outcome will be that they make you purchase the permit within a specified period of time. Compliance with this and all other laws is strongly recommended. You should contact your city and county clerks before starting your business.

### **Last but not least, permits, licenses, and insurance**

Every business will have a special set of rules regarding licensing for operation of the particular business. The most common requirements are in the areas of construction, restaurant services, liquor sales, and professional services. The permits and licenses can cost anywhere from \$100 to the cost of obtaining whatever education is required to obtain the license. My license to practice law cost over \$100,000 including tuition. Insurance is mandatory in some businesses and optional in others. Whether mandatory or optional,

insurance is usually a good idea. You can always obtain general business insurance which will have just a basic coverage.

## **En Fin**

It is very important to cover all of these bases and many others before starting your business. Governmental regulation is extensive. It is not as easy as it was when you opened your first lemonade stand and sold cups for \$.05 and used the sugar from your kitchen cabinet. Remember, all of these things must be taken care of **before** you start your business. There are various free or low cost seminars, workshops and round table discussions that deal with starting your business which can be very helpful for confused entrepreneurs. You may also want to consult your local SBDC, a small business advisor, a CPA, or an attorney.

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# TM, SM and ®, Which do I use for my name or logo?

Everyone has seen the common trademark identifiers, but few people, other than trademark attorneys, notice or know the difference. Using the appropriate symbol can be important in protecting your rights in the trademark. Understanding the symbols can prevent you from infringing upon another company's mark.

"TM" and "SM" stand for "Trademark" and "Service Mark", respectively, and have essentially the same legal effect. When you see this mark next to a name or logo, the owner is claiming the the mark is unique and owned by him. Legally, the owner is putting the entire world on "notice" that he thought of it. These symbols can be used at any time in conjunction with the goods or services. "TM" can be used with goods or services. "SM" should only be used with services.

The Symbol ® has a different meaning. It stands for "Federally Registered Trademark" and is much stronger. The owner can rest easy if he has earned one of these. The owner of a federally registered trademark owns a piece of "intellectual property" recognized by the federal government and it can be bought, sold, leased, lost, or destroyed, like any other piece of property. It is against Federal law to use the symbol ® unless the mark is properly registered.

If there is a dispute over who thought of the name or logo, the individual or company that has filed the necessary paperwork to register the trademark can walk into court with the Patent and Trademark Office official certificate, give it to the judge, and sit back. The other party has the heavy burden to prove prior use. Even if the non-registrant has proved prior use, his continued use in the mark is greatly limited by the Federal Registration.

Obtaining a Federal Trademark is a two step process. You will first want to do a comprehensive search to research if another company has begun using your mark. A general "internet search" is not sufficient. There are professional search services that will search the federal (USPTO) database, as well as all the states databases, and a common law listing of other businesses using the name, but who haven't filed for a registration. It is important to search all of these avenues because you could find something at any level that may prevent you from using your mark.

The standard of review that the Trademark office uses is "Likelihood of Confusion." This means that the marks don't have to be identical to conflict. There are essentially two elements to this standard. First, you will want to look at the name, logo, or slogan, to see if there are two trademarks that are similar in sound or meaning. Next, you will want to check to see if the similar marks are being used with products of services that are similar. This is where trademark owners get confused.

There are situations that are very clear. For example, a company the sells shoes would not likely infringe upon the mark of a company that sells cigars even if their respective marks were identical. However, it gets more complicated when you have gray areas. For example, a company may sell software, or custom software design services, or computer hardware, or computer consulting services, or computer networking services. While all of these products and services fall in different classes, there may be "likelihood of confusion" because it is reasonable for the consumer to think that one company could sell all of the above products and services. This is why it is crucial too seek legal counsel before you

begin using a name or logo.

Once the search step is clear, it is time for registration. If you are currently using your mark in interstate commerce, or plan on marketing your goods across state lines within a few years, it is always best to get a federal registration, which is the broadest and strongest protection you can have. State registrations are much weaker and your rights vary from state to state. In Illinois, contrary to popular belief, a state trademark registration does not give you exclusive rights to a mark statewide. It merely helps establish common law rights of usage and affords you some monetary remedies that aren't available otherwise.

An owner of a registered trademark should always use the ® in conjunction with the mark. Failure to use the symbol ® with your registered name or logo may cause you to lose your rights. It is the best way to put the world on notice that you mean business when it comes to your company name and/or logo.

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# Keeping Your Ideas Yours: Intellectual Property

Entrepreneurs pride themselves on their ability to come up with good ideas. After all, often, that is the reason they are in business for themselves. The entrepreneur has a new idea for a product or service that she wants to sell. The question then comes up, "How do I protect my idea?" Well, the quick answer to that question is, "You can't!" Ideas themselves are not protectable. It is the expression of that idea (Copyright), the process that is developed out of that idea (Patent), or the commercial identity that is created out of that idea (Trademark). Patent, Trademark, and Copyright are the three areas of the field of law called *Intellectual Property*.

The term *Intellectual Property* very accurately describes the field of law it covers. When we talk about *Intellectual Property*, we are talking about a person's property that has sprung out of the creator's intellect. The author of a book, for example, has used her intellect to come up with a work. Words themselves are not protectable but when they are arranged in a way in which out of those words comes a novel, or poem, that particular arrangement creates a piece of property out of the intellect of the author. When registered properly, the author can transfer that property through contracts and other agreements. Just like any other piece of property, copyrights, patents, and trademarks can be bought, sold, leased, licensed, lost, or stolen.

Patents usually cover processes or functional aspects of machinery, furniture, architecture, or other inventions. Copyrights cover works of art, music, literature, and most recently, software. Trademarks cover corporate identities. This includes all of your creative business names and logos. If you would like to protect your company name, the best way to do that is by obtaining a federal trademark, which is good in all 50 states. As of now, there is no reliable international Intellectual property commission or body of laws to protect you outside of the individual countries in which you have registered your mark. The United States is currently working to become a party to a treaty called the "Madrid Protocol" which will allow registrants to obtain rights in several foreign jurisdictions with a single filing done at the US Patent and Trademark office. At the time of the writing of this article, the US has not joined the Madrid Protocol.

A little preventative medicine early can save a lot of headaches down the road. It is always easiest to get your intellectual property rights when the idea first comes into fruition. It is always advisable to seek counsel to assist you with the protection of your legal rights.

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