University of Illinois Extension

IDEA

Initiative for the Development of Entrepreneurs in Agriculture

Business Entities For The Illinois Agripreneur

Rich Schell

An Illinois business owner has several choices under which he or she may operate a business: Sole proprietorship, Partnership (General, Limited, or Registered Limited Liability), Corporation (C, S or Close), Limited Liability Company. A business entity is like the set of clothes that a business wears to the world. Each business entity comes with advantages and disadvantages. This article provides an overview of available Illinois business entities and then discusses the single member Limited Liability Company (LLC) in more detail. Individuals planning on starting alternative agricultural ventures should pay close attention to entity planning. A new enterprise means new opportunities but it also means different risks and may require different planning.

Sole Proprietorship

A sole proprietorship is the default business choice in Illinois. If a person just opens up for business without forming a corporation or some other business entity, then he or she is most likely a sole proprietorship. Sole proprietorships are without a doubt the easiest way to go into business. The start up requirements for this way of doing business is minimal. If the business owner is conducting business under a name other than his or her own, then he or she should register the name of the company in order to fulfill the requirements of the Assumed Business Names Act.

Adding an employee means adding resources as well as complexity to the business. If a business is going to employ people, the business must comply with state, federal and local legal requirements including tax obligations for the employee.

Of all the business choices, the sole proprietorship is the easiest to get going. However, this ease of operation comes with several disadvantages. Most business people first worry about their personal liability for business obligations. Personal liability is the concern, which drives most business people to acquire an entity to limit their liability for lawsuits if something goes wrong. A sole proprietor has unlimited personal liability for claims against his or her business. For this reason, corporations, limited liability companies and limited partnerships are sometimes referred to as limited liability entities because they allow investors to limit their liability to just the amount of their investment. A person planning on doing business as a sole proprietor should pay particular attention to liability insurance. Sole proprietorships, also, may not be the best choice for entrepreneurs who plan to sell food or do agritourism since both these enterprises potentially might expose the business to extensive liability. Sole proprietorships also do not offer an easy way to raise money from others to run or expand the business. Since only one person owns it investors cannot readily own a piece of the action and banks can only lend to the sole proprietor. Another disadvantage is that if the sole proprietor dies or becomes disabled, there is no easy way for the business to keep operating.

Partnerships

A partnership may offer some advantages over the sole proprietorship. In Illinois, a general partnership is easy to get going because it is essentially a sole proprietorship with more bodies. So, it has the advantages and disadvantages of a sole proprietorship with some additional twists because of the additional bodies. Advantages to getting a partner can be very practical. Adding another person could mean another person to contribute money and time to the business.

A partnership is what is known as a "pass through" entity. This means that the tax picture looks very much like a sole proprietorship because the profit and losses of the business flow through directly to the partners' tax returns so that partners are only taxed once. However, the disadvantages must also to be weighted. Adding another person doubles the potential liability of the operation because now the sole proprietor has not only his own unlimited liability to worry about but now he has the liability of his or her partner for business acts to consider as well. General partners are liable for the actions of the other where the business is concerned. Partners have unlimited personal liability for claims on the partnership. Like a sole proprietorship the continuity of a partnership is not assured. Unless the partnership agreements specifies otherwise, the partnership will dissolve upon the death or disability of a general partner.

Limited partnerships offer a partial solution to this dilemma. Instead of having two general partners, a limited partnership has one general partner who runs the business and one or more limited partners who participate in the profits and losses but do not actually run the business. Limited partners may engage in a wide range of activities related to the partnership without risking their limited partner status. They may, for example, attend meetings and advise the general partner on running the business. However, if a limited partner exercises actual control of the running of the company he or she runs the risk of loosing his or her limited liability and becoming liable as a general partner. Limited partnerships are the first entity for which the Illinois Secretary of State requires registration with the state.

A Registered Limited Liability Partnership is also permitted in Illinois. This is essentially a partnership composed entirely of limited partners without any general partner. This requires filing with the State of Illinois. It offers the advantage of an additional liability shield for businesses such as dentistry which had been traditionally run as partnerships. For example, a partner in a registered limited liability partnership is not personally responsible for liabilities resulting from negligent acts done in the course of the partnership business by another partner.

Corporations

Corporations are the oldest and most familiar form of limited liability entity. They come in three flavors in Illinois: C, S or Close. A C corporation is the oldest and most traditional entity. It offers considerable advantages in that the tax and legal implications of operating in a C corp. are well established. In addition there can be advantages in the availability of certain tax benefits not available to other entities or sole proprietorships. One of the major advantages of a corporation is how easily capital may be raised and how easy it is to transfer ownership in a corporation by transferring its stock. Another advantage a corporation offers is the possibility of deducting some of the expenses of fringe benefits such as medical insurance for the entrepreneur/employee.

Corporations, also, have significant disadvantages. They are by far the most complex business entity to create and to administer. If the corporate formalities are not done or done incorrectly it could lead the court to conclude that the corporation was not in fact being operated as a separate legal entity. For example, if a person formed a corporation where he or she was the only shareholder and then mixed his or her personal funds with the corporate funds, a court might conclude the corporation was not really being run as a separate legal entity. Because of this, the court might allow the creditors to "pierce the corporate veil" and hold the owner of the corporation personally responsible for claims against the corporation. In addition, a partnership sole proprietorship and LLC is a "pass through" entity for tax purposes. This means that income earned by the entity goes straight through to the owner's income tax form. A C corporation however is not a pass through entity, which can lead to the problem of double taxation. The corporation's earnings are taxed at the corporate level and then the shareholder has to again pay taxes when he or she receives income from the corporation.

An S corporation may solve some of these problems by allowing income to pass through however S corporation have significant issues of their own when used for real estate. For example only U.S. citizens and permanent resident aliens may participate in an S corporation. A corporation (C or S) has to fulfill certain administrative requirements such as an annual report. Using an S corporation for real estate purposes raises tax implications that the businessperson should explore with his or her accountant or lawyer.

Illinois also allows a business to operate as a close corporation. A close corporation is essentially a C corporation that has been specially adopted for ease of administration. Like a C corporation, it offers its stockholders limited liability. Most of its advantages and disadvantages are similar to that of the C corporation. Running a business as a close corporation allows small business people to have the predictability and liability protection of a C corporation without all of the formalities. Under the close corporation form, many of the administrative requirements of the C corporation may be done away with by written agreements between the shareholders. For example, the shareholders may choose not to have a board of directors and to instead manage the company themselves. In addition, the shareholders may restrict how shares of the company are to be transferred. The disadvantages however are largely those of the C corporation. While the administrative burdens are smaller than a C corporation they are still greater than those of a sole proprietorship or partnership, and the shareholders still face the problem of double taxation.

Limited Liability Companies

Limited Liability Companies are the newest and probably one of the less familiar ways available in Illinois to organize a business. They are a company organized under an operating agreement between the members. This allows the members to organize the affairs of the LLC with a great deal of flexibility like a partnership. But, instead of the problem of a limited partnership or a sole proprietorship where someone still bears unlimited liability, the member's liability is limited to the amount that they have invested into the LLC. Ideally, running a business as an LLC can give the members the limited liability of a corporation, and the flexibility of a partnership.

An LLC, particularly a single member LLC, offers some significant advantages over these other formats of conducting business. First, an LLC offers the members limited liability. Limited liability means that if the business goes under the investor only stands to loose what he or she invested in the business. Second, like a partnership or a sole proprietorship, income from the LLC is not taxed twice. Instead an LLC is a "pass through entity", this means that the income derived from an LLC membership interest passes directly through to the individual member's tax return. For a while after LLCs were allowed in the U.S. their tax treatment by the IRS was uncertain. Now, "check the box" regulations are in effect which allow the person to make an election with the IRS to be taxed at the individual or corporate rate. However, it's very important to check the right box when filling out the forms. This eliminates the problem of double taxation, which a C corporation is subject to. Third, of the entities, which offer limited liability, an LLC could be set up to be the easiest to administer. As another example, aliens and permanent resident aliens may be members of LLCs. How long an LLC may operate is determined by the terms of the operating agreement.

No entity is perfect, however. Filing fees for an LLC are more expensive than the fees to set up a corporation. Also, corporate law has been around for hundreds of years. LLCs only came to the United States in the late 1970s so the law associated with them is much less settled than that associated with corporations.

Illinois offers a range of possibilities for the small businessperson who is looking for a limited liability entity. Each has its own advantages and disadvantages. The farmer entrepreneur should also be sensitive to the effect of transferring assets such as land into a limited liability entity. Timely consultation with an attorney or accountant can be money and time well spent.

For more information contact
Richard Knipe
Phone: 309-792-2500
Email: rknipe@uiuc.edu

UNIVERSITY OF ILLINOIS EXTENSION
College of Agricultural, Consumer and Environmental Sciences

Illinois Initiative for the Development of Entrepreneurs In Agriculture

C-FAR
Illinois Council on Food and Agricultural Research