



Should you turn your side-hustle into a legal entity?

The benefits of a legal entity could shield you from personal liability and lower your annual taxes – but only if you're ready for it.

Across the city of Chicago, small and independent businesses are helping to build the foundations of thriving local communities. These small businesses often start as informal side-hustles, allowing entrepreneurs to explore small projects and earn some money in their spare time. But when is the right moment to turn a side-hustle into a small business legal entity? What are the benefits and what are the risks involved? This guide shares some basic factors to consider as you think about the future.

The difference between a sole-proprietor and a legal entity

Many entrepreneurs who turn their side-hustles into small businesses begin as a sole-proprietor or partnership and eventually switch to a Limited Liability Company (LLC) or corporation. This decision resembles a sliding scale in the life of a business – it's unique to each person and circumstance. To make this decision, you should evaluate your business's revenue, your tax goals, your business's risk level, and your need to take on debt to grow your business.

If you own and run your business and conduct business activities under your real or assumed name, you are considered a "sole-proprietor".¹ You must register with the Cook County Clerk's Office if you are doing business under an assumed name,² and under certain circumstances, you may need to apply for a business license in Chicago. As a sole-proprietor, you and your business are essentially one person where all your business assets and debt are held under your name.

When considering forming a legal entity, we are referring to an LLC or corporation. These legal entities are treated as a separate person from you that can hold assets and debt under the entity's name.

Consider the following factors to decide if your business is at a point where forming a separate legal entity is appropriate.

1. How do I evaluate if I am making enough money to form an entity?

Net earnings

You should consider if you are making money from your business activities. The money you make is often called net earnings or net income and is calculated by subtracting ordinary and necessary business expenses from your business's gross income.³ For example, you can deduct office expenses, office

¹ The Community Law Project: A Guide to Starting your Business, July 2015, Sole Proprietorship, pp. 3.

² https://www.chicago.gov/city/en/depts/bacp/sbc/county_state_andfederalbusinessregistration.html.

³ <https://www.irs.gov/taxtopics/tc554>.



supplies, and postage⁴ (as business expenses) from your revenue, which in turn, will lower your taxable income.

Corporate formalities

Corporate formalities are steps that you must take in order for your business to qualify as a separate legal entity. In determining whether to form an entity, you should consider whether the benefits of forming an entity outweigh the costs of forming an entity and maintaining compliance with corporate formalities.

Sole-proprietorships require registering your name if you are using a name other than your own. Generally, for legal entities, Illinois requires annual reporting, which comes with a \$75 statement fee. Regardless of the business entity you choose, you must maintain any licenses, permits, or certificates your business received from Chicago, and you should check with the City to keep track of how often you need to renew them and how much you must pay.

For your business to qualify as a separate legal entity, you must separate your personal and business funds and keep accurate records. Consider how you are currently tracking your business activity, keeping documents, and reporting your financials. Using Excel or an accounting software to record your financials will help you work with banks to acquire funding, examine how your business is performing, and pay taxes. You need a business plan, financial records organized in a balance sheet, an income statement, a cash flow statement, and a realistic growth expectation. If you are already taking these actions, then forming a separate legal entity will simply be a more formal continuation of this work and will help you as a business owner.

If you are using Excel or an accounting software to build detailed financial reports, then you are on the right path. On the other hand, if you keep a running balance and are beginning to understand how to record your business activity, then work on this step or consult with a certified public accountant before forming a separate legal entity.

Are you still testing the waters or are you actively growing your side-hustle?

Generating supplemental income through an activity you are passionate about is wonderful, but your business growth goals and revenue are key drivers in deciding whether to form a new entity. If you are testing the waters, then you may want to use your side-hustle income to help you achieve other personal or financial goals. If you are taking steps to actively grow the side-hustle *and* are starting to see increases in revenue generated by your side hustle, you might consider forming an entity.

⁴ <https://www.irs.gov/instructions/i1040sc#idm140094051112688>.



As a general rule of thumb, if you are making less than or around \$1,000 net earnings through your side hustle, and do not expect to grow net earnings to around \$5,000, then consider staying a sole-proprietorship. The costs of forming and maintaining an entity may cut into your revenue, and the benefits may not outweigh the costs. On the other hand, if you are making around \$5,000 and expect your net earnings to grow significantly (for example, to \$10,000), then consider forming an entity in your growth stage so that you can grow while establishing a business credit history and holding debt and assets under your entity.

2. How do I evaluate if I am in a high-risk business?

What is a high-risk business?

High-risk businesses are ones that operate in a high-risk industry (such as construction, where injuries are more likely to occur) or that have a lot of debt (where a risk of defaulting is high). The more likely it is that accidents or professional errors will occur, the more likely it is that a claim may be filed against you.

What happens if you are in a high-risk business?

Claims against your business can increase the cost of business insurance and potentially threaten your personal assets. This is particularly true if you operate your side hustle as a sole-proprietor, the claims are successful, and your business cannot cover the damages. For example, as a sole-proprietor, if a successful lawsuit is brought against your business, the creditor will also sue you personally. If the claim is successful and your business is unable to pay the damages, then not only are your business assets at risk, but so are your personal assets.⁵

How can you protect yourself from successful claims?

Claims can come from accidents, professional errors, or debts. Consult with a business insurance agent to determine your industry risk. If you have a high debt-to-income ratio, then you are at a higher risk of defaulting if your sales decline due to externalities.

Generally, if you are a high-risk business, then you should consider forming a legal entity. Doing so will allow you to shield your personal assets from claims against your business. If you have significant personal assets, such as a home and personal savings, then you will want to shield those assets from potential risk of the business's activities. This will allow you to feel confident in investing and taking chances with your business without risking your personal assets. On the other hand, if you are a low-risk business with few creditors, then a sole-proprietorship may be adequate.

⁵ A Guide to Starting Your Business, pp. 3.



Table: Is it more advantageous to form a legal entity?

	Few Personal Assets	Substantial Personal Assets
Low Risk Business	Slight benefit or no benefit	Significant benefit
Medium-High Risk Business	Could be beneficial if you are entering a growth stage	Great benefit

For example, tree-trimmers, landscapers, and roofers are considered high risk due to the physical nature of the work. Being on a roof or in trees increases the risk of falling, and using power tools or handling a chainsaw similarly increases the risk of injury.

Another example of a high-risk business is a home daycare center with more than four children because the business provides meals (creating an opportunity for children to become sick), is responsible for the children’s safety, and must keep its house up to code and safe to ensure the children’s safety. If you care for multiple children, need a larger space, or need to re-design your home to improve your daycare, then forming an entity will help protect your home and savings from any accident or injury (it will shield you from the possibility of personal liability). Additionally, the creation of a separate legal entity provides further protection in securing a loan or a commercial lease under your new entity, rather than under your own name.

An example of a medium-risk business that can become a high-risk business is catering. At first, if you are making food out of your home and catering to people at their home or businesses, then staying as a sole-proprietorship may make sense. If your catering business is growing and you need more space to cook, more staff, or a large van, then you will benefit from forming a new entity. Forming a separate legal entity would be beneficial because by exploring a commercial lease or expanding your own kitchen, hiring several employees, or purchasing a large commercial van, you open your business up to the possibility of taking on creditors, higher rent costs, and employee liability.

An example of a low-risk business is providing DJ services at events where you are taking your equipment to your client, setting up your area, and providing entertainment. It is low risk because you are less likely to have significant creditors or require large loans to obtain equipment. But you may consider forming an entity if you are making \$10,000 and expect higher revenue, enter contracts that expose you to potential liability, purchase a van to transport your equipment, or contract events to other DJs for fees.

3. Why would I want to have limited liability?



Forming a separate legal entity is beneficial in that it provides you the advantage of limited liability. Having liability means being legally responsible to another for something that a court can enforce.⁶ Personal liability means you are personally responsible for a wrongdoing or debt, and a wronged party can collect damages from your personal assets.⁷ Business liability means the business is responsible for a wrongdoing or debt, and a party with a successful claim can collect damages from your business's assets.⁸ Limited liability means you are responsible for the money you put into your business,⁹ and you are not personally on the hook for the liabilities incurred by your business's activities.

For example, a situation where personal, business, or limited liability could arise is when you are delivering a product you sold to a customer. Delivering goods is a business activity. If, while delivering the goods, you accidentally hit a parked car, a court could find you responsible for the damage you caused to the car.

Let's explore the potential outcome of the situation based on if you have or do not have limited liability. Let's say you were successfully sued and have to pay damages; however, you do not have the funds to pay the damages with money from your business. In a situation where you do not have limited liability, the owner of the parked car can attempt to collect the money from your personal assets, like your personal savings. On the other hand, if you have limited liability, the owner of the parked car can only collect the money from your business assets, not your personal assets.

As a business owner, you want limited liability because you want to protect your personal assets. You want to be able to invest in your business without placing your personal assets, like your home, personal savings, and other assets, at risk from debts or other successful legal claims against your business. Forming a legal entity has the potential to shield you from unlimited liability because the business assets will be under the legal entity, and only the legal entity will be responsible for any claims against the business. Therefore, your risk will be limited to the money you put into your business.

Limited liability means that your personal assets are not at risk if your company fails or is sued, and your financial risk is limited to what you invest into the company. Your business is treated as a separate "person," so damages are limited to your business assets. You have no personal liability. When you form a Limited Liability Company (LLC) or corporation, that legal entity will be legally responsible for the

⁶ Liability, Black's Law Dictionary (11th ed. 2019)
<[https://1.next.westlaw.com/Link/Document/FullText?findType=Y&pubNum=223765&cite=BLACKS11THL11750&originatingDoc=1fd1ad4f2808411e4b391a0bc737b01f9&refType=DA&originationContext=document&transitionType=DocumentItem&contextData=\(sc.Search\)#co_pp_sp_223765_liability|n.||||>](https://1.next.westlaw.com/Link/Document/FullText?findType=Y&pubNum=223765&cite=BLACKS11THL11750&originatingDoc=1fd1ad4f2808411e4b391a0bc737b01f9&refType=DA&originationContext=document&transitionType=DocumentItem&contextData=(sc.Search)#co_pp_sp_223765_liability|n.||||>)>.

⁷ Id.

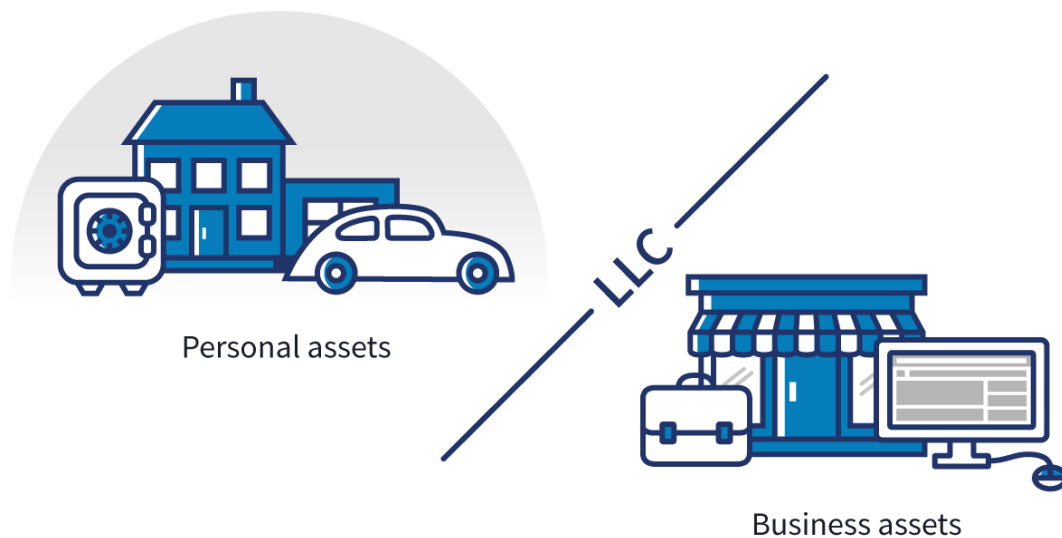
⁸ Id.

⁹ Id.

business's obligations and liabilities. For example, if your business was successfully sued, only your business assets will be at risk, even if the business does not have enough assets to pay the claim.

There are limitations to limited liability, though. In some circumstances, courts may engage in a process referred to as "piercing the corporate veil". Generally, piercing the corporate veil occurs when a business owner does not manage his or her business properly and does not engage in the proper corporate formalities (*see Corporate Formalities section above*). In this situation, if a party brings a successful claim against a business that normally would have the benefit of limited liability, and there are not enough business assets to satisfy the claim, the party may be able to recover from the business owner's personal assets. To ensure that your business is following proper corporate formalities and to avoid this scenario, you should consult with an attorney.

Unlimited liability means you personally own all the assets of your business, and your personal assets are at risk if your business fails or is sued. You have full personal liability. If you are a sole-proprietor or in a general partnership, you are fully responsible for the business's obligations and liabilities. For example, if your business was successfully sued—and the business assets are not enough to pay the claim—then your personal assets, such as your personal savings and home, could be at risk.



Source: SBA Choose a Business Structure¹⁰

Forming a separate legal entity can create a separation between your business assets and personal assets that may be at risk from your business's activities. Liability protection can come in the form of business insurance. Consider the scope of your current or potential business insurance coverage (i.e., does your coverage include personal assets?), its cost, and your assets. It is important for you to

¹⁰ <https://www.sba.gov/business-guide/launch-your-business/choose-business-structure>.



compare the cost of forming a legal entity against the cost of an insurance policy that may protect your personal assets. If forming an entity will save you money, then it may be in your best interests to do so.

Should I shield my personal assets now?

If you are in a high-risk business, you want to avoid putting your personal assets at risk. Additionally, if you are earning around \$5,000 and expect your business to grow, then you should consider forming an entity.

If you are earning less than or around \$1,000 and do not have creditors placing your personal assets at risk, then consider registering your sole-proprietorship and keep separate financials for your business to track your business activities and lower your taxes. If you grow to \$5,000 with expectations to earn \$10,000 and are considering taking on debt to help you grow, then you should consider forming an entity.

If you are in a low-risk business, have less than \$1,000 in net earnings, and do not have creditors, then consider registering your sole-proprietorship and practicing standard financial reporting to track your business activities. However, if you are growing to \$5,000 and are considering taking on debt to help your growth, then you should consider forming an entity so you can develop your business credit and acquire a loan under the entity's name.

4. How does debt place my personal assets at risk?

Let's say you need more funding to grow your business and you apply for a loan at a bank. A loan is a personal debt that is guaranteed, often by you as the business owner. When you guarantee a loan, you are personally responsible for paying the loan back. You are expected to pay the loan back with interest. If you cannot make payments on the loan with money earned through your business, then you must make payments using your personal funds. Remember, as a sole-proprietor you have unlimited liability, meaning that your personal assets and your business assets are considered the same. If you are a sole-proprietor, the loan approved for your business's use is a debt against you. On the other hand, if you operate an LLC, the loan approved for your business's use is a debt against your LLC. An LLC is a separate legal entity and can hold debt. Therefore, you can prevent your personal assets from being at risk (when the business cannot pay back the loan) if you acquire the loan under the LLC's name, and also do not personally guarantee payment of the loan. But as mentioned earlier, while an LLC can provide this level of protection, you must ensure that you are observing corporate formalities in order to prevent a court from "piercing the corporate veil" of limited liability.

When you apply for funding—through a business loan or a line of credit—forming an entity may increase your chances of approval. Lenders (i.e., banks) examine your credit history and financial information. Your credit history will show how much debt you have and how well you pay off your



debts. Having an entity allows you to build your business's credit history. By building a respectable business credit history, you can earn access to higher amount of funds and better interest rates on loans. Keeping a good account of your business and financial records will help you show lenders that the funds you requested will help your business grow and, most importantly, pay the lender back.

Forming a legal entity requires annual reporting, which will require you to have separate financials for the business. Lenders favor having a detailed history of your financial reporting because it makes it easier for you to provide detailed plans on how you will use the funds and how the funds will create value for your business.

5. Who will own your business?

If you plan on having partners or giving investors equity in your business, then forming an entity can help you avoid conflict between owners and allow you to organize ownership in the best interests of the business.

Additionally, when you have business partners or give investors equity in your business, it is important to clarify the breakdown of ownership, who has decision making power, and who manages day-to-day operations. In doing so, you should consult with an attorney to draft an operating agreement, which is a contract among all the owners in an LLC entity. Generally, an operating agreement provides the governing structure, economic terms and conditions, and other rules pertaining to your business. If the entity is a corporation, the corporation's bylaws are the equivalent governance document.

6. What's your exit strategy?

An exit strategy is your plan for retirement or sale of your ownership interest in the business. If you are interested in eventually selling your business to another person or entity, whether a business partner, investor, employee, or even a family member, then forming a legal entity may make the process of transferring ownership more streamlined.

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