CHOICE OF LEGAL ENTITY

This Article is designed to provide a basic summary about the differences between the following legal entities recognized by the State of Texas:

Corporations

- Professional Corporations
- Subchapter S Corporation

Partnerships

- Limited Partnerships
- Registered Limited Liability Partnerships
- Family Limited Partnerships

Limited Liability Companies

- Professional Limited Liability Companies

Sole Proprietors

Assumed Name Certificates or Doing Business As (d/b/a)

Joint Ventures

There seems to be two major areas of concern when deciding the formation of a business: Taxes and Liability. If a business is not operating in corporate form, professionals are taxed as individuals. That individual taxation may, however, be filtered through a form of a partnership, or limited liability company or an S corporation. This does not mean the tax results are the same for all these entities. Each has its own quirks. Likewise, each entity has different levels of liability associated with its owners.

Due to the complicated nature of the tax code and the fact that taxation is not always based on the name of the entity, but many times based on the actual characteristics and functions of the entity, it is strongly recommended that you consult competent tax, financial and legal professionals. This will help make sure you maximize your corporate structure to its full benefit. With this in mind here is a general overview of:

> **Corporation**. A corporation (Subchapter C or S) is created when two or more individuals, partnerships, or other entities join together to form a separate entity for the purpose of operating a business in the state. A corporation has its own legal identity, separate from its owners. The corporation offers protection to the business owners' personal assets from debts and liabilities relating to the operation of the corporation. Taxation of the corporation varies depending on the type of corporation formed. A corporation must be registered with the Secretary of State.

Subchapter C Corporation. A Subchapter C Corporation advantages include exemption of stockholders from personal liability; continuity of corporate existence in spite of death, incapacity of owners or managers, or changes of stockholders; transferability of ownership interest; limited liability of its stockholders; and standardized statutory methods of organization, management, and finance affording protection to stockholders and creditors.

The chief disadvantages of incorporation are the expenses of incorporation, the necessity for complying with corporate formalities in the conduct of business affairs, the necessity for complying with state reporting requirements, and potential double taxation of corporate earnings. From the tax standpoint, such disadvantage is more apparent than real, however, since the tax laws are not inflexible, and the harm that could result generally may be avoided by making proper choices and elections.

In actual practice, the decision to incorporate is often based on tax considerations. The major tax disadvantage of incorporation, potential double taxation of corporate earnings, exists only if earnings are distributed to stockholders as dividends. Bona fide interest and rental payments made by the corporation to stockholders in return for the use of money or other property loaned by stockholders for use in the corporate business are ordinarily deductible by the corporation in computing its federal and state income taxes. Even more important, the corporation will be entitled to deduct salaries paid to stockholders in their capacity as officers and employees of the corporation, and may also provide such fringe benefits as qualified profit sharing or pension plans, group term life insurance, stock bonus plans, and accident and health plans.

Subchapter S Corporation. In some circumstances, the S corporation may be a viable choice. Like the LLC, it offers the limited liability of a corporation with most (but not all) the tax characteristics of a partnership. Income and deductions flow through to the individual shareholders and usually retain their tax character in the process. The Subchapter S Corporation also offers alternative methods for distributing the business income to the owners.

The S corporation avoids many problems of the "regular" corporation. An S corporation cannot be a personal holding company and cannot hold taxable accumulated earnings. Double taxation of earnings is not possible and no question can be raised about the reasonableness of the salaries.

As with a partnership, the income of an S corporation flows through to the stockholders without being taxed at the corporate level. Most items of income and deductions retain their character when passed through, in the same manner as a partnership.

An S corporation nevertheless has drawbacks. For example, an S corporation cannot have more than 35 shareholders and shareholders are taxed on the earnings of the "S" corporation, even if those earnings are not yet distributed to the shareholder and are retained. Nor can it have a corporate shareholder or a subsidiary, or engage in financial operations (insurance, banking). The S corporation cannot issue a second class of stock

unless the only distinction between the classes relates to voting rights. There are fringe benefit problems such as any stockholder holding 2 percent or more of the stock is taxed on the value of the fringe benefits (a major exception exists for qualified retirement plans; those costs are deductible.). There are other disadvantages of an S corporation as well. Though useful in some situations, professionals have tended to shun S corporations as an entity of choice.

Professional Corporations. A Professional Corporation is organized for the sole and specific purpose of providing professional services by shareholders who are licensed or otherwise duly authorized to perform those services. The primary goal of professional organizations is to achieve for professionals a number of tax advantages available to corporate executives. Like a PLLC, the term "professional services," is defined in the act as any type of personal service that requires as a condition precedent to the rendering of the services such as a license, permit, certificate or other legal requirement. The definition applies to services that, by reason of law, cannot be performed by a corporation due to the professional's license requirements.

Persons that may form professional corporations include: accountants, attorneys, chiropractors, dentists, insurance agents, licensed insurance adjusters, licensed professional counselors, nurses, occupational therapists, optometrists, physical therapists, podiatrists, psychologists, registered public surveyors, respiratory care therapists, and veterinarians.

Conversely, the following persons form business corporations rather than professional corporations: audiologists, engineers, pharmacists, private security investigators, real estate agents or brokers, security broker dealers, and speech pathologists. These professions can incorporate under the Texas Business Corporation Act. As noted under Professional Associations, physicians, surgeons and other doctors of medicine are specifically excluded from applicability of the Professional Corporation Act.

Foreign Corporations. Are entities formed in other states or countries. Texas State law requires that the foreign corporation obtain a certificate of authority to do business in Texas. A certificate of authority will not be issued, however, unless the application for the certificate of authority states that the jurisdiction in which the foreign corporation is incorporated would permit reciprocal admission of the corporation if it were incorporated in Texas.

Professional Associations. Professional associations are regulated in Texas primarily by the Texas Professional Association Act. This act applies only to persons licensed to practice medicine by the Texas State Board of Medical Examiners, including medical doctors, osteopaths, and podiatrists.

The Texas Professional Corporation Act, specifically excludes physicians, surgeons and other doctors of medicine from the professional corporation's act. All other professionals should consider professional corporations, regular corporations, limited

liability corporations, professional limited liability corporations and registered limited liability partnerships.

The Texas Professional Corporation Act and the Texas Professional Association Act do not affect existing law concerning the confidentiality of professional relationships or the professional liability of a practitioner to his or her client.

Partnerships. A general partnership exists when two or more individuals or businesses join to operate a business. Under a general partnership, a separate business entity exists, but creditors can still look to the partners' personal assets for satisfaction of debts. General partners share equally in assets and liabilities. A general partnership requires an annual partnership income tax return (separate from the partners' personal returns). A general partnership may be operated under the names of the owners, or a different name. In either case, an Assumed Name Certificate must be filed with the county clerk.

The most complex of the taxing patterns imposed by the Internal Revenue Code is that applying to partnerships. The goal is to make partnership taxation as close to individual taxation as possible. The partnership provisions try to make income, deductions, credits, and other tax items the same in the hands of a partner as they would be if the partner were a sole proprietor.

Though taxation may be complicated as a partnership, the partnership itself is comparatively simple and it can be the most flexible. The partnership agreement can contain almost any provision desired; income and deductions can be allocated in any manner the partners choose. (These allocations must make economic sense, however, before they will stand up for tax purposes). Partnerships have no limit on their size or on the number of their members. Property may be contributed and taken out without tax consequences.

The major tax drawback of the partnership form is the inability to deduct the cost of certain fringe benefits given to partners. A profit-sharing or pension plan may not be adopted for the benefit of the partners, but a comparable plan—the Keogh plan—is available to partners on an individual basis. Lack of a qualified plan is no longer a major reason for choosing corporate form. As for the remaining benefits that are not available as deduction to a partner, that condition has not deterred professionals from choosing the partnership form.

Limited Partnership. A limited partnership is a partnership formed by two or more persons or entities, under the laws of Texas, and having one or more general partners and one or more limited partners. General partners share equally in debts and assets, while limited partners have limited debt obligations. A limited partnership must be registered with the Secretary of State.

A limited partnership affords greater protection to the limited partners than is afforded to members of a Registered Limited Liability Partnership. In a limited partnership, the

general partner (which may be a corporation) has unlimited liability and exposure for the limited partnership's debts and obligations. Members in an LLC have no such exposure.

Generally, limited partners are not liable for the limited partnership's debts and obligations unless the partners have actively engaged in the management of the business. A registered limited liability partner, on the other hand, may participate in the management or control of the partnership business and still enjoy the limited liability afforded by the RLLP.

The advantage of a Limited Partnership limits the rights of a judgment creditor to a charging order against only the income produced from that partner's interest in the partnership. The creditor may seek the appointment of a receiver to take the debtor's share of the partnership's profits. To the extent that a partnership interest is charged in this matter, the judgment creditor only has the rights of an assignee of the partnership interest. Therefore, if the general partner has the right to hold a distribution of income pursuant to the Limited Partnership Agreement, the judgment creditor may receive nothing for his or her interest in the limited partnership that the creditor has obtained.

Registered Limited Liability Partnership. A registered limited liability partnership (RLLP) is a general partnership that has been registered with the Secretary of State. A partner's liability in a registered limited liability partnership differs from that of an ordinary partnership. In a registered limited liability partnership, like a general partner, an RLLP partner is liable for general partnership debts and obligations, however, an RLLP partner is not liable for the negligence or malpractice of other RLLP partners in his or her partnership unless he or she was involved in or aware of the negligent act. A partner in a general partnership is liable for all other partner's actions in the partnership even if he or she had nothing to do with the negligent action.

Registered limited liability partnerships, like general and limited partnerships, do not pay the Texas franchise tax. LLCs, on the other hand, must pay the franchise tax.

RLLP's allow pre-existing partnerships to enjoy similar benefits to those afforded LLCs. Due to the tax consequences of disbanding a partnership and then forming an LLC, many pre-existing partnerships will prefer to chose the RLLP form instead. An RLLP has many of the same benefits of an LLC but avoids the tax consequences of changing the organization of a pre-existing partnership. For example, large firms that desire the benefits of an LLC but are wary of the tax consequences can form a RLLP.

Family Limited Partnership. Is a Limited Partnership but centered around the idea of protecting the family assets while retaining control of the management, supervision and transferability of the property interests. The partnership consists of the family members and can be an alternative to probate.

Limited Liability Company. A limited liability company is an unincorporated business entity which shares some of the aspects of Subchapter S Corporations and limited partnerships, and yet has more flexibility than more traditional business entities. The

limited liability company is designed to provide its owners with limited liability and pass-through tax advantages without the restrictions imposed on Subchapter S Corporations and limited partnerships. A limited liability company must be registered with the Secretary of State.

An LLC is created in the same manner as a corporation. Articles of organization are filed that show the full liability of each organizer. Assets of the individual members are not available for the company's obligations beyond what has been contributed. The LLC merges the limited liability of a corporation with the tax advantages of a partnership or sole proprietorship.

The theory behind the LLC is that it will be taxed as a partnership. That result, however, depends on the manner the company is formed and operated. In Texas, the LLC can be formed in a manner that will allow it to act like a corporation as it may have long terms of life, a transferability of interests, or a centralization of management pattern that permits it to operate like a corporation. Texas LLC's are taxed as a partnership rather than as a corporation and they must pay a state franchise tax.

Whatever its drawbacks, it is likely the LLC will eventually be the entity of choice for most small and medium-sized businesses.

Professional Limited Liability Company. Is like and LLC, however it is organized for the sole purpose of rendering one type of professional services and that has as its members only professional individuals or professional entities. The rendering of the professional service requires that the prior to rendering of the service, the member must obtain a license, permit, certificate of registration, or other legal authorization. Professional services include, but not limited to, services rendered by an architect, attorney, certified public accountant, dentist, doctor, or veterinarian.

Sole Proprietorship. A sole proprietorship exists when a single individual operates a business and owns all assets. A sole proprietor is personally liable for all debts, and business ownership is nontransferable. Under a sole proprietorship, the life of the business is limited to the life of the individual proprietor. The sole proprietorship makes no legal distinction between personal and business debts, and it does not require a separate income tax return. A sole proprietorship is operated under the name of the owner, or an Assumed Name Certificate must be filed with the county clerk.

Assumed Name Certificates or Doing Business As (d/b/a). If the business will operate as a sole proprietorship or a general partnership, an Assumed Name Certificate or a dba Certificate for each name (or deviation of that name) the business will use must be on file with the county clerk in each county where a business premise will be maintained. If no business premise will be maintained, it should be filed in each county where business will be conducted.

If the business will operate as a corporation, limited partnership, or limited liability company, and the business will be identified by a name other than the name on file with

the Secretary of State, an Assumed Name Certificate must be filed with the Secretary of State and each county in which the business will have a registered or principal office.

Neither the filing of an Assumed Name Certificate nor the reservation or registration of a company name imparts any real protection to the party filing the certificate. It is merely a formal process that informs the general public of the registered agent for a business and where official contact with the business can be made.

Joint Venture. A joint venture is not a specific type of tax entity. Its tax classification is drawn from its manner of formation and operation. Though a joint venture can take almost any recognizable tax form, most joint ventures are either partnerships or corporations. Joint ventures can, under some circumstances, ignore their association and retain their individual tax status for the operation.

Partnership status. Unless incorporated, most joint ventures are taxed as partnerships. Those ventures that do not incorporate choose that route to avoid corporate taxation. They purposely elect to be a partnership so the income and deductions of the venture will flow through to the venturers in their original tax form. Capital gain will not be turned into ordinary income when paid out as a dividend, for example. Such deductions as depreciation are directly deductible by the venturers if the partnership form is used.

The Code definition of a partnership includes "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a trust or estate or a corporation." No distinction exists between a partnership and a joint venture that is taxed like a partnership. Both are subject to the same tax treatment. Exemption from partnership status is available only if all members of a joint venture make that election. The election is denied if the income of the members cannot be determined without the use of partnership accounting principles.

Associations taxable as a corporation. While a joint venture may begin as a partnership, it must avoid the characteristics of a corporation if it is to maintain partnership status. Once a partnership has more corporate than partnership characteristics, it is subject to reclassification as an association taxable as a corporation.

Six characteristics decide whether a venture is a partnership or an association taxable as a corporation. Two of these are common to both partnerships and corporations. These are associations and the conduct of a profit-seeking venture. The remaining four therefore decide the tax nature of a venture. These are continuity of life, centralized management, limited liability, and free transferability of interests. If three out of these four are present, the venture is taxed like a corporation. If only two are present, it is a partnership.

Continuity of life is present if the death, retirement, or withdrawal of a member does not cause dissolution. If it does, continuity is not a characteristic of the venture. Centralized management exists if a small group has the sole authority to make management decisions. Centralized management also exists if substantially all the interests are owned

by limited partners. If interests in the venture can be transferred freely, this is a corporate characteristic. If a transfer dissolves the venture, the interest is not freely transferable.

Co-ownership of property. Mere co-ownership of property, even as a joint venture, does not always lead to taxation as either a partnership or as a corporation. Co-ownership of property, by itself, merely requires that each co-owner pick up his share of income and expense from the property. The co-owners are only investors. Even when taxpayers who are not co-owners of property unite for a project, they are not necessarily partners. For example, if persons organize to dig a ditch to drain their respective property, no income is involved, only expenses. They will report the expenses in their own individual tax returns, not through a partnership return. When co-owners of a residence jointly lease it, they are not engaged in business. Once those owners go beyond merely holding and renting property, however, they are in business and are treated differently under the tax law. If they provide services for the residence—cut the grass, haul the garbage, etc.—their tax status changes.

General IRS Tax Classification.

Professional Associations. As noted above, there are a variety of entities available to a professional who is engaged in plying his or her occupation. While these may all be classed as professional associations, for tax purposes, the term lacks specificity. The Internal Revenue Code does not recognize such an organization. Instead, the Code deals with: Sole Proprietorships; Partnerships; Professional Corporations; Limited Liability Companies; Associations taxable as a corporation; Subchapter S corporation.

As this listing show, a professional association does not exist for tax purposes. A professional association is taxed like the specific tax entity whose form has been assumed. If it is a partnership, a limited liability company, or an S corporation, the tax governing pattern is that imposed on an individual. If it is a corporation or an association taxable as a corporation, it is taxed under the corporate rules.

However, if one of these entities assumes too many corporate aspects, it is taxed as a corporation. This is also true of partnerships and any other association of professionals. Depending on their formation and their operations, they may be taxed either as a corporation or a partnership. Therefore the respect for following corporate formalities is important not only for tax reasons but for protection against individual liability.

Professional Service Corporations. Not only does the tax law not recognize a professional associations, it does not even acknowledge that a professional corporation is unique. For tax purposes, a professional corporation is the same as any other corporation. The IRS does, however, recognize the individuality of most professional corporation in an indirect fashion. The IRS Code has set up a tax classification called "personal service corporations." Most professional corporations are also personal service corporations. They are therefore subject to special rules affecting these entities.

> The definition of a personal service corporation (PSC) varies, depending on the particular Code restriction imposed. Basically, a PSC is one engaged in giving services performed primarily by its employee-owners. Substantially all the stock of the corporation (at least 95 percent) must be owned by the employee-owners. For certain rules to apply, that definition is enlarged. Those rules will apply only if the corporation is engaged in certain fields. The fields are health, law, engineering, architecture, actuarial science, accounting, performing arts, and consulting. The breadth of that listing includes most professionals. Still a third batch of rules applies only to employees who own 10 percent or more of the stock of the corporation.

We hope the above summary will assist you in deciding what type of entity is right for you. Please be advised that the above is only a partial summary of each entity. This area of law is very complicated so please feel free to consult further with us and/or your tax expert to determine which entity is right for you. We look forward to answering your questions.

Article Adapted From Westlaw and the Texas Secretary of State