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SETTING UP YOUR BUSINESS PARTNERSHIPS AND RELATIONSHIPS

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SETTING UP YOUR BUSINESS PARTNERSHIPS AND RELATIONSHIPS

This article discusses your options as a small business owner in Texas for choosing the type of legal entity that best suits your business. All businesses have different needs, so the type of entity that you choose will depend on multiple factors. In this article, we explain why you might choose to register as a formal entity, what factors you should consider when selecting an entity type, and the basic characteristics of each entity. It is always advisable to discuss your options with an attorney and an accountant to ensure that you make the best choice for your business.

Why You Need an Entity

The primary benefit of creating a formal entity for your business is to avoid personal liability for business debts and obligations. If you conduct business in Texas, either on your own or with a partner, without the protection of an entity such as a corporation, limited liability company, or limited partnership, you will be personally responsible for the liabilities of your business and for the acts that your partners take in connection with business matters. This puts your and your partners' personal assets, such as bank accounts and homes, in danger. Although a creditor must exhaust the resources of any business before seeking reimbursement from a business owner, businesses often cannot pay for all of their obligations, and it is not uncommon for a partner or sole proprietor to be left personally responsible for a debt or obligation.

Factors to Consider in Choosing an Entity Form

If you decide to form a business entity other than a general partnership or sole proprietorship in order to protect yourself from personal liability, there are a number of factors that you should consider when choosing an entity form. A few of the primary factors to consider are:

a. How the entity will be taxed under federal and state law
b. Who will be liable for the entity's contracts, torts, and statutory obligations
c. How your business will be managed
d. Whether and how the entity will raise capital
e. Whether and to what extent an owner's interest in the business should be transferable
f. How much it will cost to form the entity and the expense of maintaining the entity's status
g. Whether the entity should be formed in Texas and whether it will need to qualify to do business in other states

These factors are discussed below in our explanation of the various entities that may be formed under Texas law.

Taxation

Because it is often the most important factor for a new business to consider when choosing an entity form, we will provide a brief explanation of the three forms of taxation to which an entity may be subject.

a. Federal Income Taxation

Under the Internal Revenue Code, all entities will be taxed either as a “corporation,” a "partnership," or a “disregarded entity.” An entity need not be formed as a corporation to be treated as a corporation for federal tax purposes, and likewise need not be formed as a partnership to be treated as a partnership. An entity that is taxed as a corporation will be subject to what is commonly referred to as “double taxation.” This means that the income of the entity will be taxed and the owners will be taxed on any dividends that they receive. On the corporate level, the corporation is subject to income tax rates ranging from 15% to 35%. Owners of the entity are taxed on dividends that they receive at 15%. A major drawback of corporate taxation is that the owners of the entity will not be able to realize losses of the entity on their personal tax returns.

An entity that is classified as a partnership is a “pass-through” entity. It must file a tax return for the business, but income tax is imposed at the ownership level. This means that the entity must file a federal tax return, but the income, gains, losses, and deductions of the business are reflected on the personal tax returns of the business owners. This can be beneficial to the owners because losses of the business will be reflected on their personal tax returns. However, if the business earns income, each owner must pay taxes on this income, regardless of whether the business actually distributed the income to them. An entity that is taxed as a partnership may be attractive to new business owners because new businesses often incur losses, which could offset other income realized by the owners.

Finally, a single-owner limited liability company may be disregarded as a separate entity for federal income tax purposes (commonly referred to as a "disregarded entity"). A disregarded entity does not need to file a federal tax return for its business. The income, gains, losses, and deductions of the business will be reflected on the owner's individual tax return just as they would be if the business were taxed as a sole proprietorship (meaning a business that hasn't been organized under state law as a corporation, partnership, limited liability company, etc.).

b. Self-Employment Tax

Owners of some types of entities must pay self-employment taxes on the income earned by their business. Generally, an employer pays 7.65% of each employee’s salary for Federal Insurance Contributions Act (FICA) taxes and an employee pays the same amount out of his or her wages for a total of 15.3% of the employee’s salary. However, for entities that are subject to self-employment taxes under the Self-Employment Contributions Act, each owner must pay the equivalent of both the employee and employer portions of the FICA tax. Self-employment taxes are paid at a rate of 15.3% of the income the owner receives from his or her business. The calculation for determining the self-employment tax is slightly different from that for determining both the employer and employee portions of FICA taxes, but the total tax rate should be approximately equal for an employee of a business and for an owner who must pay self-employment taxes.

c. State Taxation

Texas does not have a state personal income tax. However, most Texas business entities must pay a franchise tax (often referred to as the "margin tax"). The margin tax applies to all business entities except sole proprietorships, general partnerships wholly owned by individuals, and entities that qualify as "passive entities." Corporations, limited partnerships, some general partnerships, LLCs, LLPs, business trusts, and professional associations must pay the margin tax. The definition of "passive entity" includes only certain non-business trusts, general partnerships, and limited partnerships. The margin tax is calculated based on the entity's gross receipts after deductions for either compensation or cost of goods sold. The tax rate applied to the Texas portion of the tax base is 1% for most taxpayers and 0.5% for a narrowly defined group of retail and wholesale businesses. There is an exemption from paying tax for some small businesses. Starting with margin tax returns filed in 2010, businesses with $1,000,000 or less in total revenue will not owe margin tax (though they will still have to file a tax return).

Law Governing Texas Entities

The Texas code that governs all business entities created since January 1, 2006 is the Texas Business Organizations Code (the "TBOC"). The TBOC uses a "hub and spoke" approach. The provisions common to all entities are found in Title 1 of the TBOC, while the subsequent titles contain provisions specific to different entity types.

Until January 1, 2010, entities created before January 1, 2006 that have not voluntarily elected to be governed by the TBOC will be governed by the statutes that formerly governed Texas entities. These statutes include the Texas Business Corporation Act, the Texas Non-Profit Corporation Act, the Texas Cooperative Association Act, the Texas Uniform Unincorporated Nonprofit Association Act, the Texas Limited Liability Company Act, and the Texas Revised Limited Partnership Act. On January 1, 2010, all of the old entity statutes will be repealed and all Texas entities will be governed by the TBOC, regardless of when they were formed.

Types of Entities

Sole Proprietorships

<u>Advantages:</u>

- No Texas margin tax
- No name requirements

- Occurs automatically without filing fees
- Simplicity of management

Disadvantages:

- Owner has personal liability for all debts and obligations of the business
- Limited to businesses with one owner

Many people who start new businesses begin as sole proprietors. A sole proprietorship is formed automatically when an individual begins to conduct business without forming a formal entity. He or she may have employees or hire independent contractors, but may not have equal partners as this would turn the business into a partnership instead of a sole proprietorship. A sole proprietor may sell his or her business without restriction.

The major drawback of a sole proprietorship is that the owner has unlimited liability for the debts and obligations of the business—including liability for his or her own unlawful acts and for the unlawful acts of employees. However, doing business as a sole proprietorship may make sense in certain instances, such as when the business owner provides personal services for which liability would attach to the business owner individually, regardless of whether or not an entity exists (e.g., medical or legal services). In such a situation, appropriate insurance coverage may be the best liability protection available; in fact, it should always be considered in any instance when liability protection is a concern.

Filing: Although a sole proprietorship is formed automatically upon an individual conducting business in Texas without forming a formal entity, a sole proprietor should follow some formalities in order to comply with federal, state, and local laws. For example, a sole proprietor should register the name of his or her business as an "assumed business name" with the Secretary of State and must pay filing fees for this service. The name is not restricted as it is with other entity types.

Taxation: A sole proprietorship is a disregarded entity for federal tax purposes. A sole proprietorship does not have to pay the Texas margin tax, but the owner is required to pay self-employment taxes based on a percentage of the business's profit.

General Partnership

Advantages:

- No Texas margin tax if all partners are individuals
- Occurs automatically without filing fees
- Flexible management options

Disadvantages:

- No liability protection for partners
- Can be difficult to raise capital

Under Texas law, a "partnership" is "an association of two or more persons to carry on a business for profit as owners" regardless of whether the partners intend to create a partnership or how the partners classify the partnership (whether they formally call the business a "partnership" or "joint venture"). A partner in a general partnership can be either an individual or an entity. This means that if an individual or entity "carries on a business" with another person or entity, they may accidentally form a partnership. The TBOC outlines multiple factors to be considered to determine whether a partnership has been formed.[1]

Forming a general partnership can be very risky because, if the partnership does not have sufficient funds, the partners are jointly and severally liable for all debts and obligations of the partnership. This means that a partner not only risks the loss of what he or she puts into the business, but also risks personal liability for all obligations that the business incurs, including obligations for the wrongful acts or omissions of other partners. For example, if the business defaults on a contract or one of the partners commits a tort while acting on behalf of the business, any other partner may be required to pay for the entire amount of the damages. However, creditors of the partnership must first exhaust the assets of the partnership before seeking a contribution from a partner, and a partner who pays more than his or her share of an obligation has a right of contribution from the other partners. Again, a general partnership may well make sense where the partners have very little exposure to risk and can sufficiently protect themselves by obtaining appropriate insurance coverage.

It is advisable for any partnership to draft a written partnership agreement to govern the terms of the relationship between the partners and the structure of the business. The management options for partnerships are very flexible. For example, partners can create multiple classes of ownership. If no partnership agreement exists, Texas statutes provide default provisions for the operation and liquidation of the partnership. For example, absent an agreement to the contrary, all partners in a general partnership have equal participation in the management of the business and share equally in the profits and losses of the business. Each partner can bind the partnership to contracts and all are jointly and severally liable for the partnership's obligations.

A partner's economic interest in the partnership may be transferred absent a restriction in the partnership agreement to the contrary. However, the assignee of a partnership interest does not gain status as a partner merely by being assigned the interest. The assignee's status as a partner depends on the approval of the other partners.

<u>Filing:</u> A general partnership, like a sole proprietorship, is not subject to any name restrictions. For example, it does not have to use the words "partnership" or "joint venture" in its title. However, every partnership should file an assumed name certificate and pay the related filing fees to the Texas Secretary of State.

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[1] These factors include: (1) sharing the profits of the business; (2) expressing intent to be partners; (3) participating in or having the right to participate in control of the business; (4) sharing or agreeing to share losses or liabilities of the business; and (5) contributing or agreeing to contribute assets to the business. TBOC § 152.052(a).

Taxation: A general partnership is taxed as a partnership for federal tax purposes. The margin tax does not apply to general partnerships if all of the partners are individuals, but does apply to general partnerships that have an entity as a partner. General partners who are individuals are subject to federal self-employment tax.

Limited Partnership

Advantages:

- Limited liability for limited partners
- Flexible governance structure

Disadvantages:

- Unlimited liability for general partners
- Limited partners may lose limited liability if they participate in management of the partnership
- Generally subject to margin tax

A limited partnership, or "LP," is a partnership between at least one "limited" and at least one "general" partner. Partners can be either individuals or entities. The general partner of an LP manages the daily affairs of the business and does not benefit from limited liability protection. It is exposed to unlimited liability just like a partner in a general partnership. However, there is no restriction on the type of entity that can be a general partner of an LP, so it is often recommended that an entity with limited liability and limited capital serve as general partner. The limited partners of an LP have limited liability like shareholders of a corporation. They are liable for obligations and debts of the business only to the extent of their capital contribution to the partnership. However, a limited partner may lose its limited status if it participates in the management of the partnership business. Safe harbor provisions of the Texas statutes governing LPs specify the activities in which limited partners can participate without being subject to unlimited liability.[2]

The management and business structure of an LP can be fairly flexible. The primary limitation is that only the general partner, and not the limited partners, can participate in the management of the business. However, different classes of partners are permitted. As in a general partnership, a partner's partnership interest is transferable absent restrictions in the partnership agreement or other agreement among the partners. The assignee of a partnership interest has the right to the assignor's allocation of income,

[2] Some of the more common of these activities are: (1) consulting with or advising a general partner of the LP on any matter; (2) acting as a guarantor for the LP; (3) calling or participating in a meeting of the partners of the LP; and (4) voting on various LP matters, including but not limited to winding up, sale of assets, incurrence of indebtedness, admission or removal of a general partner or limited partner, amendments to the LP agreement, and merger or conversion of the LP. This list is not a complete list of all actions specified in the TBOC that do not constitute participation in control of the LP for liability purposes; for a complete list, please see § 153.103 of the TBOC.

gain, loss, and deductions, but the assignee of the interest does not take on the status of a partner without the consent of the partners.

Filing: To obtain the benefits of the liability protection of an LP, a partnership must file a certificate of formation with the Texas Secretary of State. There is a filing fee of $750 for forming an LP. Furthermore, the name of the partnership must include the words "limited partnership," "limited," or an abbreviation of either.

Taxation: LPs are treated as partnerships for federal income tax purposes. They must pay the margin tax (subject to certain limited exceptions). However, limited partners generally are not subject to self-employment tax. General partners who are individuals are subject to self-employment tax.

Limited Liability Partnership

Advantages:

- Some limited liability for all partners

Disadvantages:

- $200 yearly filing costs for every partner
- If LLP does not re-register every year for LLP status, partners lose liability protection
- Subject to margin tax

A limited liability partnership, or "LLP," is either a partnership that registers as an LLP or an LP that registers as an LLP. An LP that registers as an LLP is called a limited liability limited partnership, or "LLLP." Partners of an LLP can be individuals or entities. Partners of an LLP have limited liability for business obligations and debts unless those obligations and debts are attributable to the fault of the partner. For example, a partner is liable for the actions of his or her copartner or a representative when that copartner or representative is working under his or her supervision. LLP status is beneficial for an LP because it provides the general partners with the limited liability of an LLP partner. Furthermore, it protects the limited partners of an LP by providing them protection from liability that they would not have if they participated in the management of the LP without LLP protection.

The management and business structure of an LLP is flexible. Multiple classes of partners are permitted. Furthermore, partnership interests are transferable just as they are in general partnerships and LPs.

Filing: In order to form an LLP, a general partnership or LP must register annually with the Texas Secretary of State and pay a filing fee of $200 per partner each year. This can be expensive, and the partners will lose limited liability status provided by the LLP if the LLP does not remember to re-register each year. To qualify as an LLP, a partnership must maintain a certain amount of liability insurance or be able to meet a financial responsibility test. The name of the LLP must include the phrase "limited liability partnership" or an abbreviation of that phrase.

Taxation: LLPs are taxed as partnerships for federal tax purposes. The margin tax applies to all LLPs, and partners of an LLP who are individuals are subject to the federal self-employment tax.

Corporation

Advantages:

- Limited liability of shareholders
- Centralized management
- Flexible capital structure
- Taxation as a partnership for S-corporations

Disadvantages:

- Expense of formation and maintenance
- Many required statutory formalities
- Double taxation for a C-corporation
- Restrictions on ownership and capital structure for an S-corporation
- Subject to margin tax

Corporations can be one of two types, C-Corporations or "C-corps," and S-Corporations or "S-corps." The differences between C-corps and S-corps are outlined below. However, all corporations share some similarities. The owners of a corporation are referred to as "shareholders." All shareholders benefit from limited liability, and generally can only be liable for debts and obligations of the corporation to the extent of their investment in the business.

Under the general management structure of a corporation, the shareholders, the owners of the business, elect directors. The shareholders retain the power to vote on certain major decisions of the company, but generally delegate management duties to the directors. The directors have the power to manage the affairs of the corporation and formulate policies and objectives of the business. In turn, directors can appoint officers to manage the daily affairs of the business and implement policies and objectives.

A corporation may also operate as a "close corporation" in which the shareholders manage the affairs of the business. To create a close corporation, the corporation's certificate of formation filed with the Secretary of State should indicate that the corporation elects to be a close corporation and all shareholders should agree to the close corporation management structure in the corporation's bylaws or in a shareholders' agreement.

Texas law creates multiple mandatory formalities that corporations must follow closely. Thus, management of a corporation may take more time, effort, and money than management of other entity types.

The transfer of an ownership interest in a corporation is very flexible, although transfer may be restricted by the shareholders as is the case with a close corporation. If an entity would like to make a public offering, the corporate form generally is the best option.

Filing: A corporation must file a certificate of formation with the Texas Secretary of State and pay a $300 filing fee. The name of the corporation must include the word, "corporation," "company," "incorporated," or "limited," or an abbreviation of any of these words.

S-Corporation

S-corps are generally suitable for smaller businesses that wish to qualify as corporations. They provide limited liability for shareholders like C-corps, but they are taxed in a manner that is similar to partnerships for federal tax purposes, instead of as corporations. Thus, S-corps have some benefits of regular C-corporations, but they are not double-taxed. An interest in an S-corp is freely transferable unless restricted by agreement of the shareholders.

A corporation must meet certain qualifications to elect S-corp status. First, it cannot have more than one hundred shareholders. Second, only one class of stock is permitted. Finally, only individual residents of the U.S. and certain trusts, estates, and exempt organizations can be shareholders of an S-Corp.

Filing: To form an S-corp, an eligible C-corp must make an election to be treated as an S-corp. All shareholders of the S-corp as well as their spouses (if the corporation's stock would be community property of the shareholder) must consent to this election. An S-corp easily can convert to a C-corp if it would like to rid itself of the requirements it must meet to qualify as an S-corp.

Taxation: An S-corp is taxed in a manner similar to a partnership for federal tax purposes and is subject to the margin tax. S-corp shareholders usually are not subject to self-employment tax on the share of net earnings of trade or business income if the shareholders are paid reasonable compensation for being active in the business.

C-Corporation

A C-corp is a corporation that does not elect to have S-corp status. It does not have ownership restrictions like an S-corp. It can also have multiple classes of stock. Most importantly, a C-corp is taxed as a corporation with a "double tax" on corporate income as well as on dividends distributed to shareholders. This may be a disadvantage in some businesses. However, although shareholders do not benefit from the reflection of corporate losses on their personal tax returns, under this tax structure, the shareholders are not taxed on income of the business that is not distributed as they would be under the partnership taxation form.

If a company would like to raise capital through a public offering of stock, a C-corp generally is the best option. Shareholders can come and go with ease in the absence of a restrictive shareholders' agreement, which might add value to the company. If it is not likely that a new business will want to make a public offering in the near future, it can always elect S-corp status and later convert to a C-corp as needed to raise capital.

Taxation: A C-corp is taxed as a corporation for federal tax purposes, as described above. It is subject to the margin tax, but shareholders are not subject to federal self-employment tax.

Limited Liability Company

Advantages:
- Limited liability of members
- Can specifically allocate income and losses among members
- Flexible management structure
- Can be taxed as a partnership or corporation (or disregarded entity if only one member)

Disadvantages:
- Subject to the margin tax

A limited liability company or "LLC" has many of the benefits of a corporation and a partnership combined. The structure of an LLC is similar to that of a corporation. The LLC's owners are called "members." All members have limited liability like corporate shareholders, even if they participate in management of the business. Either an individual or an entity can be a member, and an LLC need not have more than one member.

The structure of an LLC is very flexible. LLC members create a Company Agreement that dictates the terms of the business, and have great leeway in deciding how the company will be structured. The Company Agreement does not have to be filed with the state, but it is generally signed and agreed upon by all members. An LLC may have multiple classes of ownership. It may be structured either like a close corporation or like a traditional corporation. LLCs that are structured like close corporations are "member-managed." In a member-managed LLC, the members manage the daily affairs of the company. LLCs that are structured more like corporations are "manager-managed." In manager-managed LLCs, the members elect managers to deal with the company's daily affairs just as shareholders elect directors to manage a corporation. The managers, in turn, can elect officers and agents to be responsible for specific tasks.

An interest, or "membership interest," in an LLC is transferable unless it is restricted by the members in the Company Agreement. However, as with partners in a general partnership, absent an agreement to the contrary, the assignee of an interest does not become a member and cannot participate in the management or affairs of the company without consent of the other members. Each member makes a capital contribution of money or another asset to the company.

Filing: To form an LLC, the members must file a certificate of formation with the Texas Secretary of State and pay a $300 filing fee. The name of the company should include the words “limited liability company,” “limited company,” or an abbreviation of either phrase.

Taxation: An LLC is generally treated as a partnership for federal tax purposes if it has more than one member. However, it can also elect to be taxed as a corporation. A single member LLC will be a disregarded entity unless it elects to be taxed as a corporation. All LLCs are subject to the margin tax. Members may also be subject to self-employment tax.

Other Entities

Entities such a non-profit corporations, professional associations, professional corporations and professional limited liability companies are beyond the scope of this article. Please be aware that these types of entities may be subject to special tax treatment and/or have restrictions on who may hold ownership interests.

Conclusion

Any new business should carefully select the type of entity it forms. This article is meant to help new business owners with an overview of their options. The entity that might work for one business may not be optimal for every business. We suggest that you consult both an attorney and an accountant to determine the best option for your business.

EXHIBIT A
Comparison Chart For Entities Governed by the TBOC

Type of Entity	Filing Fees	Tax Treatment	Limited Liability of Owners for Entity Obligations?	Subject to Texas Margin Tax?	Individual Owners Subject to Self-Employment Tax?	Other Restrictions
Sole Proprietorship	State ($20) and county (approximately $20) fees for assumed name certificate filing.	Disregarded entity.	No.	No.	Yes.	Only one owner allowed.
General Partnership	State ($20) and county (approximately $20) fees for assumed name certificate filing.	Treated as a partnership (pass-through taxation).	No.	No, if all partners are individuals. Yes, if any partner is an entity.	Yes, for partners who are individuals.	
Limited Partnership	$750 filing fee for Certificate of Formation.	Treated as a partnership.	Yes, for limited partners. No, for general partners.	Yes, subject to limited passive entity exemption.	Yes, for general partners who are individuals.	Limited partners who participate in management may lose liability protection.
Limited Liability Partnership	$200 yearly filing fee per partner.	Treated as a partnership.	Yes.	Yes.	Yes, for partners who are individuals.	Partners lose liability protection if LLP fails to file annually.

Type of Entity	Filing Fees	Tax Treatment	Limited Liability of Owners for Entity Obligations?	Subject to Texas Margin Tax?	Individual Owners Subject to Self-Employment Tax?	Other Restrictions
S-Corporation	$300 filing fee for Certificate of Formation.	Treated as a partnership (must make election).	Yes.	Yes.	No, if shareholders pay selves a reasonable salary for being active in business.	No more than 100 shareholders; Shareholders must be individual U.S. residents; No more than one class of stock. Mandatory formalities required by TBOC.
C-Corporation	$300 filing fee for Certificate of Formation.	Treated as a corporation ("double taxation")	Yes.	Yes.	No.	Mandatory formalities required by TBOC.
Limited Liability Company	$300 filing fee for Certificate of Formation.	Treated as a partnership by default, but may elect to be treated as a corporation. Single-member LLCs are disregarded entities.	Yes.	Yes.	Maybe.	