

Business Entity Selection - Basic Considerations*

A for-profit enterprise¹ must deal with and select the entity-form in which to exist and conduct its commerce. The selection process ultimately entails an evaluation of the facts and circumstances applicable in each specific instance. However, there are several key issues which are commonly present and should be considered in most instances. Some of these common issues include: limitation of legal liability, minimizing federal and state tax cost, industry-specific requirements, fulfillment of financing requirements, administrative cost/reporting requirements, efficiency of management structure, compensation issues, and implementation of exit strategies.

1. **Types of Entities.** The following is a non-exclusive list of basic and most frequently encountered entity-formats² employed to conduct various commercial activities: sole proprietorship, unincorporated joint venture, general partnership, limited partnership, limited liability partnership, limited liability limited partnership, C corporation, S corporation, professional corporation, limited liability company, professional limited liability company, professional association.

2. **Liability Limitation.** In most situations, the desire to limit legal liability drives the ultimate choice of entity selected for most business ventures.

(a). **Partnership Form.** Generally, a limited partner is liable for partnership indebtedness only to the extent of the capital the partner has contributed or has agreed to contribute. A general partner has unlimited liability for partnership indebtedness.

(b). **Corporate Form.** A corporation is a distinct and separate legal entity apart from its owners (shareholders). A corporation is liable for its debts to the extent of its assets. Except under exceptional circumstances, the shareholders are not personally liable for the corporation's debts beyond their investment in the corporation.

(c). **LLC Form.** Like corporations, a limited liability company is a distinct and separate legal entity apart from its owners (called members). A member of a LLC, whether or not designated as a manager (similar to a director of a corporation) of the business, has no personal liability for the debts or obligations of the LLC. The member's (owners) ability to participate in the management of the LLC without jeopardizing the liability-limitation feature is a major advantage over other entity-types.

*This summary is intended to provide general information regarding the subject matter addressed. It is not legal advice and cannot be relied upon as such. For legal advice, please contact one of our firm's attorneys.

3. **Administrative Considerations.** The three basic forms of entities (partnership, corporation, LLC) differ in terms of cost and on-going administrative burdens. These include initial filing fees, preparation of organizational documents, maintenance of corporate formalities, and filing of federal and state tax returns.

(a). **Partnership.** To form a general partnership, generally, no public-filing is necessary. Hence a general partnership can be formed with little formality. However, preparation and execution of a partnership agreement is generally necessary. Most states recognize an oral partnership agreement as well. Unlike a general partnership, a limited partnership is subject to various filing formalities. It must file a certificate of limited partnership with the applicable state officer and pay the required filing fees. The limited partnership must prepare a limited partnership agreement which must be executed by the limited partners and the general partners.

(b). **Corporation.** As compared to other forms of entities, a corporation is relatively an expensive form of entity to organize and operate. To organize a corporation, an incorporator must prepare and file certificate/articles of incorporation and pay the required filing fee. Simultaneously with the formation, other organizational documents such as bylaws and organizational consents must also be prepared. Upon completion of subscription of shares (equity ownership), share certificates must be prepared and issued to shareholders. To establish the management structure, shareholders must elect directors who in turn appoint officers to manage the daily business operations of the corporation. A corporation is generally subject to a state income or franchise tax in the state of incorporation, and may be subject to income or franchise taxes in other states in which it does business. If a corporation does business in more than one state, it also must obtain a certificate of authority from, and maintain a registered agent in, the states in which it does business.

(c). **LLC.** A LLC is organized by the filing of certificate/articles of organization with the applicable state officer. Generally, a LLC maintains an operating/LLC agreement (similar to a limited partnership agreement) specifying how the entity will be managed. This agreement roughly serves the same purposes as bylaws, organizational consents, as stock certificate issuance in case of a corporation. Most states require foreign LLC to qualify itself to do business before commencing business operations in such states.

4. **Legal Characteristics and Tax Treatment.** The three basic entity formats (partnership, corporation, LLC) can be further fine tuned into variants to address specific business concerns. However, depending upon the nature of the new enterprise, the sole proprietorship format must also be evaluated as a potential vehicle to conduct business³.

(a). **Sole Proprietorship.** A sole proprietor (single owner) conducts the business in his or her individual capacity. Accordingly, no separate legal entity is formed for holding and conducting the business. A sole proprietor may adopt a separate name (assume name) to conduct the intended business activity. Since no separate entity exists for federal income tax purposes, no separate income tax return is required in the case of a sole

proprietorship. The financial (taxable) results of the sole proprietorship are reported on a separate schedule (Form 1040, Schedule C) attached to the sole proprietor's personal tax return.

(b). Partnership. A partnership is a pass-through entity for federal income tax purposes. The tax rules applicable to partnerships are set forth in Subchapter K of the Code. Although it is required to file a tax return (Form 1065) no tax is due with the filing of such return by the partnership. Instead, all of the taxable items of the partnership are passed on to the partners on Form K-1 for reporting and payment of applicable tax on each such partner's personal tax return.

(c). LLC. Generally for federal income tax purposes, a LLC with more than one owner (member) is taxed as a partnership and a LLC with single owner is disregarded (no tax return is required) as an entity. Accordingly, a multiple owner LLC files a partnership tax return and a single-owner LLC is taxed as if it is a sole proprietorship.

(d). C Corporation. For federal tax purposes a C corporation is taxed on its net taxable earnings as a separate taxable entity. A C corporation files its tax return using the Form 1120. The profits accumulated after the payment of the corporate level tax are subject to additional federal income tax upon distribution (dividends) to the shareholders. The double-taxation feature of a C corporation makes it the most tax-cost-inefficient entity format.

(e). S Corporation. A corporation that has an S election in effect is able to avoid the double-taxation feature of a C corporation. The tax rules applicable to S corporations are set forth in Subchapter S of the Code. To qualify, S-election (Form 2553) is required to be filed with the IRS within time-limits specified by the Code. The practical effect of the S-election is that the S corporation becomes a pass-through entity for federal tax purposes. Although it is required to file a tax return on Form 1120S, no tax is due with such return. Instead, all of the tax attributes of the S corporation are passed on to the shareholder on Form K-1 for reporting and payment of applicable tax on each such shareholder's personal tax return.

5. Check the Box Rules. For federal tax purposes, the "check the box" rules generally permit an unincorporated entity to elect (on Form 8832) to be treated as a corporation or a partnership but only if it has more than one owner. Those entities organized as corporations under applicable state law, certain foreign entities, those entities which are required to be taxed as corporations under specified provisions of the Code, and trusts are not allowed to select their entity classifications under the check the box rules. There are default rules which obviate the need to file any election if the default status is what a taxpayer is looking for. Under the default rules, a non-corporate domestic entity with more than one owner is treated as a partnership and single-owner domestic entity is disregarded. These rules allow business owners a great deal of flexibility in the selection of the most desirable tax treatment for federal tax purposes without sacrificing state law liability limitation.

6. **Texas Margin Tax.** Effective January 1, 2008, the new margin tax replaces the Texas franchise tax. It applies to virtually all business entities (whether formed in Texas or elsewhere) except certain passive-income vehicles. Rentals from property are specifically excluded from the definition of passive income. To qualify as a passive entity, a business must be organized as a general partnership, limited partnership or non-business trust. The margin tax is calculated by multiplying a taxable entity's taxable margin by the tax rate of 1%, or 0.5% for retailers and wholesalers. No tax is owed if the tax due is less than \$1,000 or if the taxable entity's total revenue from its entire business does not exceed \$300,000. The taxable margin is the lesser of (i) 70% of the taxable entity's total revenue on its entire business or (ii) the taxable entity's total revenue on its entire business minus either (x) its cost of goods sold or (y) its compensation expense. The election to subtract cost of goods sold or compensation expense is made by the taxable entity on its franchise tax report, and the election is valid for that report only. This approach allows the taxable entity to select the method that will produce a lower margin tax liability.

¹ This paper does not address entity choices for non-profit or foreign entities operating in the U.S.

² There are many other entity formats (not discussed here) which are formed and used to serve a variety of specialized industry or business goals. Examples include REIT, RMIC, RIC, FASIT, cooperatives, trusts, banking corporations, insurance corporations, trade associations, and commercial or residential owners' associations.

³ Since the Texas margin tax is a franchise tax (although practically an income tax), it does not apply to sole proprietorship. Depending upon the nature of a proposed business enterprise and to the extent Texas margin tax liability is likely to be a significant factor, sole proprietorship should be evaluated along with possibility of obtaining sufficient insurance to account for any potential liability issues.