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How do I select the proper business entity?

Our firm counsels clients on the best choice of entity after carefully reviewing a business owner's particular set of facts and circumstances. For many professionals and business owners, the choice of entity is also influenced by the interest in or need to do effective asset protection planning as well as tax and estate planning. You might wish to see other FAQs that address these issues.

The decisions you make about your business structure will have a long-term impact on you and your business. Some of the factors that one should consider include:

- The type or nature of the business
- Number of owners and employees
- Financial and tax issues
- Types of assets
- Business liability and control
- Transferability of ownership interests
- Personal liability
- Effect on your personal estate planning

A description of the various types of business entities is provided in a separate FAQ entitled <u>What are the different types of business entities?</u>

What are the different types of business entities?

A detailed chart is provided that illustrates relevant issues and compares the various business entities available under Texas law.

However, a very general description of several popular business entities follows, including the sole proprietorship, general partnership, corporation and limited liability company.

<u>Sole Proprietorship/General Partnership</u>

The sole proprietorship or general partnership is the simplest business structure to form. No formalities are required and they are the "alter egos" of the business owners. If one operates under an assumed name, the owner(s) must file an assumed name certificate and in the case of a general partnership or a sole proprietorship with employees, obtain a taxpayer identification number from the IRS.

If the partners in a general partnership do not have a partnership agreement, then it operates under the Texas partnership statutes. Each partner is individually liable for all debts and obligations of the partnership and for wrongful acts of other individual partners.

There is no liability protection for either the sole proprietorship or general partnership. Sole proprietorships are disregarded entities for purposes of taxation. Profits and losses flow directly to the business owners in a general partnership.

<u>Corporation</u>

The corporation is a popular form of business organization. In Texas, it is created by filing Articles of Incorporation with the Secretary of State. Texas corporations are governed by the Texas Business Corporation Act.

A corporation does provide limited liability for its shareholders if the corporate structure is respected. As a general rule, the recovery of a judgment creditor is limited to the assets of the corporation and a shareholder's liability is limited to the shareholder's investment in the corporation.

In some circumstances, the courts have disregarded the corporate entity under a doctrine known as "piercing the corporate veil". In that case, the courts will hold the shareholder responsible for the corporation's action as if it were the shareholder's own. Some of the circumstances under which courts have pierced the corporate veil include those where the corporate form is used to perpetrate fraud, evade an existing legal obligation, to justify wrongdoing or circumvent other laws.

Certain formalities should be observed to respect the corporate structure and to prevent it from being disregarded. For suggestions regarding these formalities see FAQ entitled

What are the annual or periodic maintenance items I must do to legally maintain my business?

Our firm counsels business owners to meet annually with an attorney to review the corporate books and ensure adherence to formalities.

All corporations are subject to a franchise tax in Texas. See FAQ regarding failure to timely file or pay the Texas franchise tax.

Limited Liability Companies

The limited liability company has become a popular vehicle for effective tax, estate and asset protection planning.

A limited liability company is a separate legal entity created by statute and is subject to the Texas Limited Liability Company Act. It is a hybrid organization that has characteristics of both a corporation and a partnership. Members receive interests in the LLC in exchange for property, money or services.

The limited liability company provides the limited liability protection of a corporation; however, it has the tax advantages of a partnership thereby avoiding the double taxation for shareholders in a corporation. The LLC is liable for the Texas franchise tax just like a corporation. The LLC has a more flexible ownership and management structure without some of the legal formalities that govern corporations.

What are the annual or periodic maintenance items for corporations that I should do to legally maintain my business?

Our firm counsels business owners to meet annually with an attorney to review the corporate books and ensure adherence to formalities.

Some of the things we advise shareholders to do are:

- Keep the minute book up to date with minutes of annual and special meetings
- Maintain separate financial records and bank accounts
- Issue stock certificates and maintain the stock ledger
- Adhere to corporate by-laws
- All important transactions, such as large expenditures, long-term leases, contracts, compensation plans, shareholder distributions, etc. should be reflected in resolutions or minutes of meetings of the shareholders and Board of Directors
- Insure that the corporation is adequately capitalized and insured

Business owners are advised to respect these formalities to prevent the corporate structure from being disregarded. Failure to respect these formalities could result in courts disregarding the corporate entity. See discussion regarding “piercing the corporate veil” within FAQ entitled What are the different types of business entities?

Can I change business entities after I have already chosen one?

In general, a business can change its legal structure after it is formed and doing business. However, changing the business form can sometimes cause tax liabilities to the business or its owners that could have been avoided by initially choosing the best business structure.

Do I need a buy-sell agreement with my business partners?

The well-advised business owner will include a buy-sell agreement when forming a LLC or corporation with multiple business owners. An effective buy-sell agreement, sometimes called the shareholder agreement, will protect remaining owners as well as the family of a deceased partner. Generally, the buy-sell agreement will govern what happens in the event of:

- Dispute between owners
- Death of a partner
- Disability or retirement of a partner
- Desire of an owner to sell his or her interest to a third party.

Without a well-drafted buy-sell agreement, parties can easily wind up spending large sums of money settling these issues in court.

What if I am a Texas company doing business outside of Texas?

If you are a Texas business opening an office or acquiring property in another state (or vice-versa) you may be required to qualify as a foreign company to be authorized to do business in that state. This entails filing your Articles and paying initial and annual fees. Failure to qualify may prohibit you from suing to enforce your contracts in that state or from receiving actual notice if you are sued.

Business owners are advised to seek legal counsel if considering doing business in another state.

What are the consequences for failure to timely file and pay the Texas franchise tax?

After the initial filing, the Company must file a franchise tax report on or before May 15 of each year. If the Company fails to pay its annual franchise tax, it will be subject to a penalty and interest on the amount unpaid and may forfeit its right to do business in

Texas. If the Company forfeits its right to do business in Texas, the officers and directors may become personally liable for any debts which arise during the time of the forfeiture.