

WHICH BUSINESS ENTITY TO USE: AN INTRODUCTION

In Texas, business are generally created and operated in one of the following structures, recognized by statute:

- Sole proprietorship
- General partnership
- Limited Partnership
- Registered Limited Liability Partnership
- Corporation, and
- Limited Liability Company.

As you might imagine, the most appropriate business entity in any particular situation depends upon the objectives of the business that will utilize that entity. Two main concerns of business owners should be how the entity and its owners will be taxed, and how much protection the entity will afford the owners from liabilities arising out of its activities. Because all entities formed after January 1, 2006 are governed by the new Texas Business Organizations Code (TBOC), this paper will focus on business formed since then.

Sole Proprietorship

This is what exists when a single individual engages in a business activity without formal organization. One can create a sole proprietorship just by going into business. If a fictitious name will be used in conjunction with the business, the owner should consider filing an assumed name certificate for his/her county, or for each county where he/she does business. The difficulty with maintaining this form is that, once you begin to grow and need to obtain investment capital from outside sources, it no longer works. Investors or others with an equity interest must have an entity they can buy "shares" in.

General Partnership

A Texas general partnership is an oral or written association among two or more principals with a shared interest in a venture, with an agreement to share profits and losses, and a mutual right of control or management of the enterprise. In Texas, a partnership can merge with a

corporation, limited liability company, or another partnership. It may also convert from one form of entity to another without going through a merger or transfer of assets.

Limited Partnership

A limited partnership is a partnership formed by two or more persons, having at least one general partner, and at least one limited partners. A limited partnership is now subject to franchise tax like any other filing entity. One recognized down side to a limited partnership is the requirement of additional record keeping and tax returns when, as is usually the case, another entity is created to be the general partner. Along with the increased costs of formation, the Secretary of State filing fee for limited partnerships is significantly greater than for other types of entities discussed below.

Limited Liability Company

An LLC is created when one or more persons file a Certificate of Formation, similar to a certificate of limited partnership and articles of incorporation, with the Texas Secretary of State with a \$300.00 filing fee. The existence of the LLC begins when its certificate of organization is issued by the Secretary of State. The name of an LLC must contain words or an abbreviation to designate the nature of the entity, whether the words —Limited Liability Company, or _____ Limited Company, or the acronyms LLC or LC.² LLC's may be structured to be governed by managers, or by the members themselves. Members may be individual persons, or business entities. Additionally, an LLC may designate officers or other agents to act on its behalf. An LLC will use regulations or an operating agreement rather than the bylaws used by a corporation, and may or may not choose to keep minutes of its meetings.

Corporation

A corporation is an independent legal entity, separate from the people who own, control and manage it. The owners of a corporation are called shareholders. A corporation is managed by its board of directors, which may be as few as one natural person. Day to day management is performed through the officers, which must consist of at least a president and a secretary. Corporations are typically formed to shield the shareholders, officers, and directors from personal liability for the debts and obligations of the entity. Shareholders have limited personal liability for the business debts of the corporation.

Filing

The Texas Secretary of State does not distinguish between corporations using the above designations. The distinction has more significance as a matter of law in the way the entity operates in relation to its partners, members or shareholders and third parties. When a certificate of formation is filed with the State of Texas, either a business corporation or a non-profit is created. Designations such as C, S, or 501(c)(3) relate only to federal tax provisions.

Deciding Which Entity to Use

While the ultimate decision on which, if any, entity to utilize for your business rests with you, that decision turns largely on which of the palate of advantages and disadvantages of a given entity fit the facts unique to your business. Things like what industry you operate in, what risks present themselves on a frequent or infrequent basis, how many equity holders there will be, and the importance of raising capital from outside sources all come to mind. Your attorney, aided by your accountant, is usually the best resource for making the final choice.

The Importance of Keeping Control of Your Business

No matter what entity choice you settle on, you will be well advised to guard against the dissipation or dilution of your control of the company. The unbridled right to transfer an equity share in a business by sale, by will, or through a divorce or even in bankruptcy can be curtailed or eliminated by proper planning. In a closely held company, which fits the description of most small and growing businesses, you should be concerned about what happens to equity your company if one of the principals gets divorced, dies, wants out, or becomes insolvent. There are ways to agree how to handle such potentially cataclysmic events in advance by agreement. The right time to forge such an agreement is at the very outset, when all of you are still friends. This is not a task for amateurs, or as simple as preparing a "form". Invariably, business owners who attempt to do so end up regretting it, paying huge legal fees to unravel the mess they created. Consult with your attorney on how to properly negotiate and prepare an enforceable shareholder, buy-sell, or stock restriction agreement.