CHOICE OF ENTITY

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Author, *Texas State Tax Update—Changes from the 2003 Legislative Session*
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I. INTRODUCTION

The choice of holding entity for businesses is often one of the first issues that investors must address. For most small businesses, the entity-related issues almost always revolve around five overriding themes: taxes, returning the owners' investments, ease of management, consequences on sale, and personal liability.

This paper addresses many different issues involved in forming and restructuring entities that own businesses in Texas. The second section offers a brief overview of the new Texas Business Organizations Code. The third section describes the seven main issues attorneys should discuss with clients in connection with entity choice. The fourth section examines seven different entity options clients have for holding and operating Texas business projects in light of the considerations described in Section III. The fourth section also analyzes some of the common structures used for Texas business projects.

The fifth and sixth sections of this paper address a client's ability to restructure entities in midstream or in connection with the sale of a project. The fifth section describes two different restructuring options in detail.

II. THE NEW BUSINESS ORGANIZATIONS CODE

The Texas Business Organizations Code, which codified and unified the Texas Business Corporations Act, the Texas Non-Profit Corporations Act, the Texas Revised Partnership Act, the Texas Revised Limited Partnership Act, the Texas Limited Liability Company Act, and other Texas business statutes, became effective January 1, 2006.

The Business Organizations Code was not intended to make many substantive changes to Texas entity law. The goal of the codification project was to unify entity law and adopt uniform laws to govern issues that cut across entity forms, such as mergers, conversions, filing guidelines, and indemnification. A new "common" terminology was also adopted; for example, "Articles of Incorporation," "Articles of Organization," and "Certificate of Limited Partnership" were all replaced by a the general unifying term, "Certificate of Formation." Texas business attorneys will no doubt be making substantial modification to their standard forms of entity agreements to adopt this new vernacular.

The new Business Organizations Code will automatically govern all entities formed in the state after January 1, 2006, and all foreign entities registering to do business in the state after January 1, 2006. Entities formed prior to January 1, 2006, will continue to be governed by applicable prior statutes until January 1, 2010, when all entities doing business the state—both Texas entities and foreign entities—will be governed by the new code.

Entities governed by prior law may opt to be governed by the Business Organizations Code by filing an election with the Texas Secretary of State. The Secretary of State has promulgated a form for making the election. *See* Tex. Sec. of State Form 808 (for Texas entities) and Form 809 (for foreign entities). The filing fee for the form is $15 for a for-profit entity and $5 for a non-profit entity.

III. CONSIDERATIONS FOR ENTITY STRUCTURING

Attorneys should consider seven different factors in choosing the proper holding businesses located in Texas. These seven factors are: tax minimization (from both a federal and state perspective), flexibility for making allocations and distributions, flexibility for making partial and complete liquidations, the owners' ability to manage and control the entity, limiting the owners' personal liability, protecting the entity from owners' creditors, and applicable administrative costs.

A. Tax Minimization

Taxes always play an important role in entity choice. The type of entity utilized by a client will impact both federal taxes and Texas state taxes.

1. Federal Taxation

The Internal Revenue Code classification of an entity will determine how it is taxed by the federal government. Choosing an entity that provides pass-through federal taxation usually alleviates most clients' federal tax concerns. Entities with pass-through taxation benefits will not pay any tax at the entity level but instead will file an informational return and issue K-1s to their equity owners. Owners will report the amounts shown on their K-1s on their individual tax return.

Other federal tax issues include whether or not owners will be liable for self-employment tax because of their participation in the entity and whether or not an entity will be a "disregarded entity" for federal tax purposes. Unless an affirmative election is made with the IRS, certain single-owner entities are disregarded

as entities separate from their owners under the regulations to the Internal Revenue Code. Treas. Reg. § 307.7701-3. Disregarded entities are not required to file any returns with the IRS, and the activities of the entities are passed through and reported directly on the owner's individual tax return as if the owner operated the business as a sole proprietorship.

2. Texas State Taxation

Texas Tax Code § 171.001 imposes the Texas franchise tax on corporations and limited liability companies that are doing business in the State of Texas. During the 2003 and 2005 legislative sessions (the 78th and 79th Texas Legislatures), the legislature considered a number of proposals that would have required some or all Texas partnerships to pay the franchise tax. Although none of the proposals passed during the regular session, the Legislature considered the proposals again during a special session of the 78th Legislature in the spring of 2004 and is expected to consider the issue again in a special session of the 79th Texas Legislature anticipated in the spring or summer of 2006.

During the 79th Legislature's regular session, both the House of Representatives and Senate made proposals for sweeping changes to Texas taxes. Below is a summary of each legislative body's regular session proposals.[1]

House of Representatives. The House of Representative's version of H.B. 3 included the following:

- The maximum real property ad valorem tax rates would have been reduced from about $1.50 per $100 of appraised value to $1.15 (and later to $1.10).
- The franchise tax would have offered taxpayer's a choice. Taxpayer's could pay either (i) the existing franchise tax or (ii) a 1.15% payroll tax. The taxpayer's election would have been binding for three years. The category of taxable entities would have been expanded to include any business with employees, with some exclusions.
- The state sales tax rate would have increased from 6.25% to 7.25%, and the sales tax would have been extended to include bottled water, billboard advertising, motor vehicle repair and washing, and elective cosmetic surgery.
- Other state taxes, such as cigarette taxes, tobacco taxes, and taxes on the sales of boats and motor vehicles would have been increased. The House also considered a 3% snack tax.

Senate: The Senate's proposals for H.B. 3 included:

- Reducing real property ad valorem taxes in approximately the same amounts as the House's proposal.
- The franchise tax would have been extended to most for-profit entities and also provided taxpayers a choice. Under alternative one, the taxpayer would pay 2.5% of the sum of its net income and employee wages, adjusted by subtracting the lesser of 50% of the wages or $30,000 per employee. Alternative two would require taxpayers to pay a 1.75% payroll tax, capped at $1,500 per employee. All taxpayers would be required to pay a minimum tax equal to 0.25% of its gross receipts plus allocable income.
- The state sales tax rate would have increased from 6.25% to 6.75%; the tax base remained largely unchanged.
- Other state taxes, such as cigarette taxes, tobacco taxes, taxes on the sales of boats and motor vehicles, alcohol excise taxes, and mixed beverage gross receipts taxes would have been increased.

These proposals were debated, amended, and amended further but ultimately failed to garner enough support in the regular session for passage. After the governor vetoed the public school spending bill, the legislature was forced into the first of two special sessions. In the first special session, the House of Representatives passed a bill that would have enacted limited changes to the franchise tax. Among the changes included in this bill were (1) changing the nexus rules to close the so-called "Delaware Sub" loophole so that limited partners in Texas limited partnerships would be required to pay the franchise tax if they owned a controlling interest in the partnership and (2) closing the so-called "Geoffrey's" loophole by requiring Texas taxpayers to add-back into their franchise tax calculations certain royalty and interest payments and management fees paid to out-of-state related parties. The first special session ended before the legislative bodies could agree on the final version of the bill. A second legislative session commenced but ended without any action being taken.

[1] The legislature's proposals changes numerous times. The summaries that follow highlight provisions that were included in the final forms of the bills.

After all of the proposals failed, the franchise tax remained unchanged. At the present time, a task force created by the governor is formulating new proposals, one of which includes expanding the franchise tax—at a much lower rate (one percent has been mentioned)—to all for-profit Texas business; the idea of a payroll tax has reportedly been "rejected." *Tax Panel on Uncharted Course*, Austin American Statesman, Feb. 12, 2006.

The current Texas franchise tax is imposed for the privilege of doing business in Texas. The concept of "doing business" generally equates to the legal concept of nexus. An entity has nexus with the State of Texas for Texas franchise tax purposes if it is incorporated or organized under the state's laws or if it is conducting a minimal amount of activity in the state.[2]

Subject companies must pay franchise tax at the rate equal to the greater of (1) 0.25% of net taxable capital and (2) 4.5% of net taxable earned surplus. Tex. Tax Code § 171.002(a). The net taxable capital of a company is roughly equivalent to the value of its balance sheet equity while its net taxable earned surplus is roughly equivalent to its federal taxable income. No tax is due if both tax calculations yield a total tax due of less than $100. Tex. Tax Code § 171.002(d)(1).

As part of the Texas Legislature's tax reform measures passed in 1999, Texas taxpayers received a new franchise tax exemption. The "Small Corporation Exemption" provides that no franchise tax is due from a company whose total gross receipts for the applicable year (as determined in accordance with the franchise tax statutes and Comptroller rules) are less than $150,000. Tex. Tax Code § 171.002(d)(2). A taxpayer must qualify for the exemption on a yearly basis. Because the exemption is tied to gross receipts and not asset value, a company could theoretically own and operate a business with a multimillion dollar value and, so long as the project produces less than $150,000 of gross receipts, not owe any franchise tax.

Federal law prevents the State of Texas from taxing a company's non-Texas income. Texas complies with this federal prohibition by requiring Texas taxpayers to "apportion" their income among all of the states in which they do business. The Texas apportionment formula is based on gross receipts. Therefore, Texas only taxes a fraction of a company's income; this fraction is equal to the company's Texas gross receipts divided by the company's total gross receipts. Texas Tax Code § 171.106.

The state comptroller has enacted lengthy rules governing the manner of apportionment of various types of gross receipts. These rules assist taxpayers in determining whether a gross receipt should be a Texas receipt and thus taxable in Texas. *See* Comptroller Rules (34 TAC) §§ 3.549 & 3.557. If a receipt is not apportioned to Texas, the amount of the receipt will not be taxed by the state. According to the Comptroller's apportionment rules, revenues from the sale, lease, rental, sublease, or subrental of real property are apportioned to the state where the real property is located. Comptroller Rules (34 TAC) §§ 3.549(d)(32) & 3.557(d)(28). Revenues from fire and casualty insurance proceeds are apportioned to the location of damaged or destroyed real property. Comptroller Rules (34 TAC) §§ 3.549(d)(21)(B) & 3.557(d)(18)(B).

B. Flexibility for Allocations and Distributions

The flexibility for making non-pro-rata allocations and distributions of capital, profits, and losses affect how the owners' investments in businesses are returned to them. Flexibility in allocations refers to an entity's ability to direct certain profits and/or losses to certain investors in the project. Flexibility in distributions refers to an entity's ability to vary the timing of the distributions of cash to the investors in the project. Because of the business realities and negotiations among the investors in businesses, flexibility for allocations and distributions can be an important factor in entity choice.

C. Flexibility for Partial and Complete Liquidations

As business operations progress, the relationship among the investors and the affairs of individual investors sometimes change. An entity's full or partial

[2] Before the 2003 legislative session, Texas Tax Code §171.001 also provided that an entity that was "authorized to do business" in the state must pay Texas franchise taxes. The Texas State Comptroller's policies and rules stated that a foreign entity that maintained a certificate of authority to do business in the state was automatically "authorized to do business" in the state under § 171.001 and must pay Texas franchise taxes. *See* Comptroller Rule (34 TAC) 3.546 (pre-2003 version). In 2000, the Third Court of Appeals decided in *Rylander v. Bandag Licensing Corporation* that the Comptroller's policy of taxing a company whose only connection with the state is the holding of a certificate of authority to do business in the state violated the U.S. Constitution. *Bandag*, 18 S.W. 3d 296 (Tex. App.—Austin 2000, pet. denied). Effective September 1, 2003, the Legislature codified the holding in *Bandag* by removing the "authorized to do business" provision from Tax Code § 171.001.

distribution of assets to some or all of the investors in undivided interests may become necessary. Attorneys should advise clients of the wisdom of choosing an entity with the flexibility to accommodate owners' needs in this area.

D. Owners' Ability to Manage and Control

Many investors will want to ensure that they have the ability to participate in the management and control of all aspects of the business operation. Some entities are more flexible than others in this area.

E. Limiting Owners' Personal Liability

Limiting the investors' personal liability for claims is another paramount issue. Investors may shy away from a project where there is any risk of personal liability over and above their actual investment in the deal. Assisting the investors in choosing an entity that provides limited liability protection is another important task for the attorney.

F. Protecting the Entity from Owners' Creditors

Different entity forms may be negatively affected when an owner's creditors assert their rights against the owner's assets—including his or her interest in the entity. Investors should consider choosing an entity that is not impacted by the financial condition of its owners.

G. Administrative Costs

Investors should consider administrative costs, including both the upfront costs associated with forming an entity and the ongoing costs of operating an entity. Although this issue may not drive the entity decision for the client, making the client aware of these real (and relative) costs during the entity decision process will help prevent the client from being surprised after the formation of the business.

IV. CHOOSING THE ENTITY FORM

This section discusses the advantages and disadvantages of seven different ways to own and operate businesses in Texas. The discussions will include an analysis of each of the considerations discussed in Section III of this paper. Appendix C of this paper contains a chart summarizing the analysis of each of the seven forms of ownership.

A. Seven Choices for Operating Businesses

1. Individually

Because of liability concerns, many businesses are not owned directly by the individual investors. But when appropriate, there are some advantages to direct individual ownership. First, from a federal tax perspective, no tax returns other than the individuals' personal returns need to be filed. The individuals will report their share of profit or loss from the project on their individual returns. But, an individual owner will be required to pay self-employment tax. As an additional tax benefit, individuals are not subject to any Texas franchise tax liabilities or reporting requirements. A third benefit is that, because the investors own the project individually, they will have complete freedom to manage and control the project. Fourth, administrative costs are limited to the preparation of additional federal tax schedules, accounting costs, and insurance costs.

Owners will not have the freedom to make non-pro-rata allocations of profits and losses or disproportionately timed distributions of cash. Because there is no entity level at which to make the allocations and distributions, the owners cannot enjoy this benefit. If multiple owners enter into a tenants-in-common agreement to try to create this benefit, the arrangement may under some circumstances be considered a general partnership for federal tax purposes, thus creating partnership reporting requirements. IRC § 761. Without an entity, however, the flexibility for partially or completely liquidating the business is maximized.

The primary reason is it is inadvisable to own businesses individually is that the owners will have personal liability for any and all issues connected with the project and the business' assets will be subject to any claims by the owners' creditors. From contract liability to tort liability, owners may individually be named as defendants, be forced to defend lawsuits, and be forced to satisfy any judgments. Also, personal creditors will be able to enforce debts against business assets. For these reasons, businesses should only be owned individually if the investors are completely comfortable with the liability risks. Of course, one way to ameliorate the risk of personal liability is for individual owners to obtain adequate amounts of insurance against the insurable risks on the property.

2. C Corporation

Despite the federal tax disadvantages, C corporations remain the most widely used entities for complex operating companies because of their flexibility for implementing employee benefit plans and retirement plans. Small businesses, however, typically do not need to take advantage of this type of

flexibility. So, the federal tax disadvantages usually preclude the use of C corporations.

State law does not recognize any difference between C corporations and S corporations. The Business Organizations Code authorizes the creation of for-profit corporations in Texas, but does not differentiate between C corporations and S corporations. The "C" and the "S" arise by virtue of the corporation's federal tax elections. No election needs to be made for a corporation to be taxed as a C corporation—that is the default federal treatment. A corporation must qualify and file a timely election in order to be taxed as an S corporation. IRC § 1361. For the most part, Texas state laws are neutral as between C corporations and S corporations. S corporations are discussed more completely in Part 3 of this Section IV-A.

C corporations provide the least favorable tax treatment of any of the entities discussed in this section. C corporations must pay an entity-level tax based on their corporate level profits. The corporation's shareholders must then pay taxes on the dividends they receive from the corporation. This creates the "double taxation" problem associated with C corporations. This federal double tax usually makes it inadvisable to own and operate businesses through a C corporation. The corporation's shareholders will not be required to pay self-employment tax. C corporations must, however, pay the Texas franchise tax unless they qualify for the Small Corporation Exemption by having less than $150,000 of gross receipts in each applicable year.

Another disadvantage of C corporations is that the owners will not have flexibility for making allocations and distributions or for partially or completely liquidating the property out of the corporation. Other than as compensation, the only way corporations transfer profits to their shareholders is through dividends, which must be declared for all shareholders on a pro-rata per-share basis. It is also difficult for corporations to transfer undivided interests in the property to the shareholders as a partial or complete liquidation of the entity without recognizing taxable gain.

A final disadvantage of C corporations results from the ability of shareholders' personal creditors to gain control of the shareholders' stock in the corporation. A personal creditor of the shareholder can, subject to Texas debt collection laws, attach the stock and vote the stock. A disastrous result would be the that creditor controls enough stock to direct the corporation's business affairs or become actively involved in the management of the corporation. A well-drafted shareholders' agreement (also called a "buy-sell" agreement) could ameliorate this result by requiring the stock be redeemed by the corporation, enforcing the agreement against the creditor could be costly and time-consuming.

Apart from the negative tax treatment, loss of flexibility, and power of shareholders' creditors, C corporations do have many advantages. First, there are no restrictions on who can be a shareholder, and all shareholders have the complete freedom to participate in the control of the entity as either directors or officers of the corporation. Second, shareholders cannot be held personally liable for corporate debts unless a court holds that a plaintiff may "pierce the corporate veil." Piercing the corporate veil is an unusual occurrence in corporations. A court may decide to pierce the corporate veil in three situations: (1) the failure of the entity to observe corporate formalities, (2) domination of the corporation by one shareholder to perpetuate a fraud (the so-called "alter ego" theory), and (3) undercapitalization. *See e.g., Lucas v. Texas Industries, Inc.*, 696 S.W.2d 372 (Tex. 1984). As long as a corporation does not engage in fraudulent activities, observes all of the necessary corporate formalities, and is adequately capitalized or maintains adequate insurance to protect itself from liabilities, it should be able to withstand a piercing the corporate veil challenge.

A final advantage of corporations is that they have relatively low administrative costs. Most attorneys can create corporate documents rather efficiently, and the state filing fee for Certificate of Formation is only $300. Corporations will have ongoing accounting costs for preparing the corporate tax return each year.

3. S Corporation

S Corporations are state law corporations that qualify and have elected to be taxed under subchapter S of the Internal Revenue Code. S corporations avoid the entity-level tax levied against C corporations. Instead, S corporations are pass-through entities file an informational return with the IRS and issue individual income statements (K-1s) to each shareholder. The shareholders then report their share of income or loss on their individual tax returns. In order to qualify to make a subchapter S election, the corporation must not: (1) have more than 75 shareholders, (2) have shareholders other than individuals (or certain estates, trust, non-profit corporations, or disregarded entities), (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock. IRC § 1361. The

corporation's shareholders will not be required to pay self-employment tax.

Because they are state law corporations, S corporations must pay the Texas franchise tax unless they qualify for the Small Corporation Exemption by having less than $150,000 of gross receipts in each applicable year. The franchise tax returns must be prepared as though the corporation did pay an entity-level tax to the IRS (for the earned surplus component of the tax). This unfavorable Texas tax treatment usually steers investors away from forming an S corporation to own a business in Texas unless the projects are small enough to qualify for the Small Corporation Exemption.

Other than the difference in federal taxation, S corporations enjoy the same benefits of C corporations as to management and control, low administrative cost, and limited liability for the shareholders (subject to piercing the corporate veil challenges). S corporations are also saddled by the same lack of flexibility for allocations, distributions, and liquidations as C corporations, and they may be negatively affected by shareholders' creditors. In addition, S corporations may not have multiple classes of stock.

4. General Partnership

The term "general partnership" encompasses any arrangement where two or more partners have an agreement that creates an entity level for the ownership, operation, and management of a business. This includes improperly prepared tenants-in-common arrangements and almost all joint ventures. An entity does not need to be registered with the State of Texas to be a general partnership.

The general partnership will receive the pass-through tax benefits of subchapter K of the Internal Revenue Code. The partners will report their share of partnership income or loss on their individual tax return. Partners in a general partnership will be subject to federal self-employment tax. IRC § 1402(a). The general partnership will not be liable for the payment of Texas franchise taxes because it is not a corporation or limited liability company.

General partnerships will enjoy great flexibility for making allocations and distributions to the partners. As long as the special allocations have "substantial economic effect" in accordance with the rules outlined in Treasury Regulation 1.1704-1, the allocations will be respected by the IRS. If the IRS or a court determines that certain allocations do not have substantial economic effect, then the profits and losses of the partnership will be reapportioned in accordance with the "true" interests in the partnership. Treas. Reg. 1.1704-1. The partnership can freely time distributions to partners and can make partial or complete liquidations of one or more partners' interest in the partnership property.

Partners are free to fully participate in the management and control of the general partnership, but the price they pay for this privilege is a lack of liability protection. General partners will be jointly and severally liable, on an individual basis, for all debts and liabilities of the general partnership. Therefore, the general partnership and the partners should protect themselves with an adequate amount of insurance.

The remedies of the partners' creditors are not limited by statute. Creditors of a partner in a general partnership will be able to exercise all of the tools of collections law, including garnishment, attachment, and turnover, to enforce a judgment against a partner. *See* Tex. Revised Partnership Act § 5.03, cmt. 5.03.

Because general partnerships do not register with the state, administrative costs are fairly low. The only significant costs will be the initial drafting of the partnership agreement and the ongoing accounting costs associated with managing the entity and preparing its federal tax returns.

5. Limited Partnerships

A limited partnership is a partnership with 2 tiers of ownership. There are one or more general partners and one or more limited partners. A limited partnership must file a Certificate of Formation with the State of Texas.

The IRS taxes limited partnerships in the same way that it taxes general partnerships. Limited partnerships receive the same pass-through tax benefits under subchapter K of the Internal Revenue Code, so there is only one level of tax paid by the individual partners. Limited partnerships do not pay Texas franchise tax.

General partners must pay self-employment tax, but limited partners traditionally have not been required to pay self-employment tax on their distributions from the partnership. IRC § 1402(a)(13). A limited partner does owe self-employment tax on guaranteed payments or other payments he or she receives for providing services to the partnership. *Id.* Regulations proposed by the IRS in 1997 may complicate the determination of whether or not limited partners must pay self employment tax. The regulations propose replacing the bright-line rule that partners that are considered limited partners by state statute do not pay self-employment tax with a more

functional rule. Proposed Treas. Reg. 209824-96, 62 Fed. Reg. 1702 (1/13/1997).

Under the functional test, an individual will be treated as a limited partner that does not owe self-employment tax unless the individual (1) has personal liability for debts of the partnership under state law, (2) has the authority to contract on behalf of the partnership under state law, or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. *Id.* The proposed regulations encountered substantial political opposition, and the U.S. Congress passed a resolution stating that the proposed regulations should be withdrawn and placing a moratorium prohibiting the final issuance of regulations before July 1, 1998. BNA, *U.S. Income Series*, 2002. Although the moratorium has expired, the IRS has not taken further action with regard to the proposed regulations. *Id.*

Because limited partnerships are treated the same as general partnerships for federal tax purposes, limited partnerships enjoy the same flexibility for making allocations, distributions, and complete or partial liquidations of partnership property so long as the special allocations have substantial economic effect.

The general partners in a limited partnership will have joint and several liability for all debts and liabilities of the partnership. Tex. Bus. Org. Code § 153.152. For this reason, most investors elect to form a corporation or an LLC to act as the general partners in a limited partnership (this is discussed more fully in Part B of this Section IV). The limited partnership may indemnify the general partners for such liabilities. Tex. Bus. Org. Code § 8.101. Unless a limited partner is also a general partner or has participated in the management and control of the partnership, limited partners will not be individually liable for the obligations of the partnership. Tex. Bus. Org. Code §153.102.

An additional advantage of the limited partnership form is that a partner's creditors will not be able to assert control over the partner's partnership interest. A creditor's remedies are limited to obtaining a charging order against the partner's interest, which will require the partnership to pay the creditor any amounts owed to the partner, but will not allow the creditor to gain voting or management control of the partnership interest. Tex. Bus. Org. Code § 153.256. The creditor's rights will be limited to the rights of a assignee of a partnership interest. *Id.*

One apparent disadvantage of limited partnerships is that the limited partners have some restrictions on their ability to participate in the management and control of the entity. In some circumstances, limited partners may lose their limited liability protection if they participate in the management and control of the partnership. Texas Business Organizations Code § 153.103 provides a safe harbor list of activities that a limited partner can conduct without being considered to be "managing or controlling" the partnership. The list includes, among other things: (1) acting as the agent, officer, director, or stockholder of a corporate general partner of the partnership, (2) acting as the agent, officer, director, or limited partner of a partnership that is the general partner of the partnership, (3) acting as the agent, officer, director, or member of a limited liability company that is the general partner of the partnership, (4) consulting with or advising the general partner on any matter, including the business of the partnership, (5) acting as a surety, guarantor, or endorser for the partnership on any matter or guaranteeing an obligation for the partnership, (6) proposing, approving, or disapproving activities of or changes in the partnership, and (7) acting as an employee of the limited partnership. Tex. Bus. Org. Code § 153.103. The safe harbor list includes almost all of the management and control activities a limited partner might reasonably wish to conduct. So, as long as the limited partners respect the partnership formalities and carefully limit their management involvement to activities on the safe harbor list, their limited liability shield should remain intact.

A limited partnership may have higher administrative costs than the other entities because a second entity is usually formed to act as the general partner. This will cause the investors to shoulder ongoing administrative and accounting expenses for two entities. In addition, the filing fee for a Certificate of Formation for a limited partnership is $750. Limited partnership must also file periodic reports upon request from the Secretary of State; the filing fee for each of these reports is $50.

6. Limited Liability Companies

The Texas Legislature created limited liability companies, or LLCs, in 1991 as an alternative entity form that combined characteristics of partnerships and corporations. LLCs take advantage of the Internal Revenue Code's pass-through taxation treatment like partnerships do, but LLCs do not have the limited partnership's complicated two ownership tiers or the general partner's lack of liability protections. And except for the fact that LLCs must pay the Texas franchise tax, they can take advantage of most all of the positive aspects of corporations and partnerships.

LLC members pay only one federal tax at the member (owner) level—the entity itself does not pay federal taxes. If a project will be owned by a single investor, the investor may desire to form a single-member LLC that will be a disregarded entity for federal tax purposes. Treas. Reg. § 301.7701-3. As a disregarded entity, the LLC will not have to file an informational return or issue an income statement to its member. Instead, the single member will simply report the LLC's income or loss on his or her individual tax return as if the LLC were a sole proprietorship.

The question of whether LLC members must pay self-employment tax has not been resolved by the IRS. Under a strict reading of IRC § 1402, only state limited partners in a limited partnership avoid paying the self-employment tax. The proposed regulations passed by the IRS in 1997 would adopt the functional test described in Part 5 of Section IV above for determining whether a member of an LLC must pay self-employment tax.

In a single-member LLC, the member will pay self-employment tax on 100% of the income received from the entity because (unless an alternative election is made) the entity is disregarded by federal law and the individual is treated as if he or she were a sole proprietor of a sole proprietorship. IRC § 1402; Treas. Reg. § 301.7701-3.

LLCs have the same flexibility that partnerships do for making special allocations and distributions and for making complete and partial liquidations of partnership property. Written Regulations generally govern the operation of an LLC. The Regulations normally combine the provisions included in a corporation's bylaws and in a typical limited partnership agreement. The members of an LLC may fully participate in the management and control of the entity without liability for company claims or debts.

LLCs provide the same liability shield for their members that corporations do for their shareholders. Members of an LLC are not individually liable for the obligations of the entity. Tex. Bus. Org. Code § 101.114. Although Texas courts have not yet addressed the issue of whether the piercing the corporate veil doctrine applies to LLCs in the same way that it applies to corporations, the reasoning used by Texas courts in the corporate cases can logically be extended to include LLCs. Therefore, attorneys should advise clients that it is likely that (1) disregarding LLC formalities, (2) the domination of the LLC by one member to perpetuate a fraud, and (3) undercapitalization could all lead to the loss of limited liability protection for the LLC's members.

An additional advantage of LLCs is that, similar to limited partnerships, a member's creditors will not be able to assert control over the member's LLC ownership interest. A creditor's remedies are limited to obtaining a charging order against the member's interest. Tex. Bus. Org. Code § 101.112. The creditor's rights will be limited to the rights of a assignee of a membership interest, thus the creditor will not be able to gain voting or management control of the membership interest. *Id.*

The charging order limitation may not hold for single-member LLCs, however. In a recent Colorado bankruptcy court case, a creditor of the member in a single-member LLC was allowed to assert management control of the membership interest even though the Colorado LLC statute allowed only a charging order. *See In re Albright*, 291 B.R. 558 (Bankr. D. Colo. 2003). A similar result would probably be reached in Texas because enforcing the charging order limitation against creditors makes less sense when there are no other LLC members to protect.

LLCs have comparable administrative costs to a limited partnership except that there will only be ongoing administrative and accounting costs for maintaining one entity. Except for the lower state filing fee ($300 as compared to $750), formation costs for an LLC are comparable to limited partnerships because the required legal documents are more akin to a partnership agreement.

7. Limited Liability Partnerships

While some commentators have concluded that limited liability partnerships, or LLPs, provide owners with broad and complete liability protection from third party claimants or creditors, the author of this paper believes some uncertainty remains in this area because Texas courts have not yet interpreted the statutory provisions that create the LLP's liability protections. In addition, another drawback to the use of LLPs is that the Texas statutes specifically provide that the LLP partners will remain liable for their own malpractice and negligence. Tex. Bus. Org. Code § 153.801. This is an undesirable result for an LLP partner that is an individual because that partner will have no liability shield for his or her own malpractice or negligence in operating the business.

If all of the LLP partners are entities, and if Texas courts construe the Texas Business Organizations Code as providing broad and complete liability protection to LLP partners similar to members in an LLC or limited partners in a limited partnership (except for the LLP partners' own malpractice or negligence), then LLPs

may become a more common business holding entity in Texas because (1) they have the positive attributes of federal partnership accounting, (2) they do not pay Texas franchise taxes, and (3) they have simplicity in internal governance and formation similar to LLCs (i.e., no separate general partner is necessary). LLP partners are required to pay self-employment tax. One other disadvantage to LLPs is that they have additional administrative costs—LLPs are required to pay an *annual* renewal fee to the state equal to $200 per partner. Tex. Bus. Org. Code § 153.802.

B. Traditional Texas Structures

The Texas franchise tax and limited liability issues discussed above should drive most investors to use Texas limited partnerships with a one-percent (or less) corporate or LLC general partner to purchase, own, and operate successful businesses in Texas. The Small Corporation Exemption to the Texas franchise tax has opened the door in small transactions for the use of entities that owners have typically shied away from solely because of the franchise tax.

1. Limited Partnership

Texas limited partnerships provide good liability protection to the limited partners against obligations of the partnership. In addition, limited partnerships do not pay Texas franchise tax thus preventing the outflow of tax dollars at the entity level to the State of Texas and avoiding the cost and effort of filing a Texas franchise tax return. Limited partnerships also allow the partners to structure allocations and distributions to, in accordance with the "business deal" between the partners, properly provide tailored incentives to "sweat equity" partners. And, as stated above, limited partnerships have the freedom and flexibility to partially or completely liquidate the property out of the partnership to the partners in many cases without the liquidation being considered a taxable event.

Because the general partners of the limited partnership will be jointly and severally liable for all of the obligations of the partnership, most owners will choose to form one or more limited liability entities to act as the general partner. These entities are usually S corporations or LLCs. Both an S corporation and an LLC will provide limited liability protection to their owners, but if there is to be more than one owner, an LLC will provide more flexibility for making allocations, distributions, and liquidations out of the entity to the owners. It is more difficult to unwind multiple owners out of an S corporation, but the S corporation is probably less expensive to form and maintain. In either instance, the entity general partner typically owns only a very small percentage of the limited partnership interests—usually only an aggregate 1%.

Because of the charging order limitation on creditors' remedies, business owners might be best protected by forming a multi-member LLC to act as the general partner of the limited partnership. If a corporation is used, a creditor of a corporate shareholder may take control of the shareholder's stock, and by virtue of controlling the general partner, may be able to assert control of the limited partnership as well. The charging order limitation that protects LLC owners—especially in the context of a multi-member LLC—would prevent this result. Using a single-member LLC may not offer the limited partnership similar protection from creditors of the single member.

Businesses owned by a single investor may also use the Internal Revenue Code's disregarded entity rules to simplify their federal tax reporting requirements. If the investor forms a single member LLC to be the sole 1% general partner of the partnership and then acts individually as the sole 99% limited partner of the partnership, the partnership will be disregarded for federal tax purposes. The partnership is disregarded because the general partner LLC is disregarded, thus leaving the partnership without two partners. PLR 200008015. The partnership will not have to file an informational return with the IRS or issue K-1s to its partners. Instead, the individual investor will be able to directly report the partnership's income or loss on his or her individual tax return as if it were a sole proprietorship. The entity structure will not, however, be ignored for state law purposes. The single owner will still benefit from the limited liability aspects of the entities, and the LLC will have Texas franchise tax obligations.

2. Choices for Smaller Projects

The Texas franchise tax's Small Corporation Exemption for companies that have less than $150,000 in gross receipts during the applicable year has opened the door to use S corporations or LLCs for smaller projects when the owners are confident that they will always qualify for the exemption. S corporations and LLCs are preferred over limited partnerships when they can qualify for the franchise tax exemption because they have a less-complicated one-tier ownership scheme. They also have the benefit of only expending administrative costs to maintain one entity.

Projects where the net operating income or profit of the entity will be relatively small may also be good candidates for using LLCs or S corporations. One possible scenario is where fair market rental rate cause a lessor entity to have little or no income after expenses and available deductions. In this case, even if the gross rent received from the tenant is greater than $150,000, the relevant real estate entity will owe little or no franchise tax under the earned surplus component because the tax base for earned surplus component is roughly equal to the entity's federal taxable income after Schedule C deductions. The entity may still owe tax under the taxable capital component of the franchise tax depending on the balance sheet value of the property and the amount of debt carried on the property, but capital is taxed at a much lower rate than earned surplus (0.25% as compared to 4.5%). If the owners decide to utilize an LLC or S corporation for the reasons discussed in this paragraph, they will likely need to convert the entity to a partnership that is not subject to franchise tax at the time the project is sold to avoid a 4.5% franchise tax on the gain realized from the sale.

If flexibility for making allocations, distributions, and liquidations among multiple owners is important, an LLC is preferable to an S corporation. Businesses with a single owner might consider using an S corporation because they are less expensive to form and maintain. One important drawback of S corporations is that it is more difficult to restructure S corporations into partnerships later on if the project no longer qualifies for the franchise tax exemption; this is discussed more completely in Part C of Section V.

V. RESTRUCTURING OPERATING PROJECTS

Projects that were initially formed as LLCs or corporations may find it financially beneficial to restructure the ownership entity into a partnership form that does not pay the Texas franchise tax. The fact that partnerships do not pay franchise tax has spawned the creation of many restructuring techniques designed to be federally tax neutral and to minimize franchise tax liability. This Section IV and the attached Appendices analyze two of the most common restructuring strategies—the asset drop-down and the conversion. For convenience purposes, both planning strategies will discuss the planning in terms of a project that was initially owned by a C corporation called ABC Corp that is owned entirely by individuals. The planning principles are similar for projects initially owned by LLCs. Part C describes some special issues concerning the conversion technique and S corporations. Before implementing a restructuring strategy, the attorney should submit the facts to the Texas State Comptroller in the form of a taxability inquiry and obtain a favorable taxability ruling.

A. Asset Drop-Down Restructuring

Asset drop-down restructuring involves changing the ownership of the business assets to a Texas limited partnership with ownership interests equivalent to the prior corporate or LLC form. The planning technique is fairly straightforward; Appendix A describes the planning pictorially. In this planning technique, ABC Corp could also be an LLC or an S corporation.

1. ABC Corp will form a wholly owned non-Texas subsidiary ("Holding Company") with cash. Holding Company is usually formed in Nevada or Delaware because of favorable state tax laws. Holding Company must use an out-of-state service provider to act as its official registered agent for service of process in the foreign state so that it does not do any business in the State of Texas. If Holding Company inadvertently creates tax nexus with the State of Texas, the benefit of the asset drop-down planning will be lost. Holding Company should be a corporation so that it may utilize favorable Texas apportionment rules.

2. ABC Corp and Holding Company will form a Texas limited partnership. ABC Corp contributes the company's operations to the limited partnership in exchange for a 1% general partnership interest and a 98% limited partner interest. Holding Company contributes cash equal to 1% of the value of ABC Corp's operations to the limited partnership and receives a 1% limited partner interest in exchange for its contribution.

3. Simultaneous with the contributions described above, ABC Corp contributes the 98% limited partnership interest to Holding Company. After the contribution, Holding Company will be a 99% limited partner in the partnership, and ABC Corp will be a 1% general partner in the partnership.

In the end, the Texas limited partnership will own and operate the company's business. This entity does not pay franchise tax. One percent of the profits and losses from the partnership flows to ABC Corp, which pays franchise tax on this 1%. Ninety-nine percent of the profits and losses from the operations will flow to Holding Company. The Texas Comptroller Rules state that owning a limited partner interest in a Texas limited partnership does not create nexus with the state for franchise tax purposes. Comptroller Rule (34 TAC)

3.546(12)(B).[3] The version of H.B. 3 passed by the House of Representatives in the first 2005 special session would have changed this rule and prevented taxpayers from using this restructuring strategy. But, under current law, as long as Holding Company performs no activities in Texas that would create nexus under the tax statutes or Comptroller Rules, Holding Company will not pay franchise tax on its 99% of the partnership income.

When Holding Company dividends its 99% of the partnership income to ABC Corp, the dividend will not be apportioned to Texas because of the location of payor rule. The location of payor rule prevents ABC Corp from paying taxes on the dividend to the State of Texas. The end result is that 99% of the profit and loss of the limited partnership will flow to the owners and escape Texas franchise taxation.[4]

The main disadvantages of the asset drop-down approach are that (1) it is expensive to employ and (2) its purpose is destroyed if Holding Company inadvertently creates nexus with the State of Texas for franchise tax purposes. The costs will include forming two new entities and maintaining them on an ongoing basis. Holding Company's out-of-state service provider will also charge an annual fee for the services that it provides. In addition, all of the assets of ABC Corp must be transferred to the limited partnership, and titled assets must be retitled in the limited partnership's name.

As a continuing matter, Holding Company must take special care not to conduct any activity that might be considered "doing business" in Texas under the Comptroller's Rules. At a minimum, Holding Company should maintain bank accounts in its state of formation, maintain an address in its state of formation, hold meetings in its state of formation, and conduct all formal business from its location in its state of formation. Failure to avoid creating nexus with Texas will make Holding Company's 99% distributions from the Texas limited partnership subject to the Texas franchise tax.

B. Conversion Restructuring

Another restructuring strategy that ABC Corp could employ is a conversion strategy. The goal of this strategy is to convert ABC Corp into a Texas limited partnership using a state law conversion without creating additional federal tax obligations. The steps for implementing this strategy are described below.

1. The shareholders of ABC Corp form another Texas corporation or LLC ("New Texas Co") and contribute an aggregate 1% of the ABC Corp stock to New Texas Co.

2. ABC Corp performs a state law conversion into a Texas limited partnership by filing Articles of Conversion with the Texas Secretary of State. The owners' aggregate 99% of the ABC Corp stock will be converted into an aggregate 99% limited partnership interest in the new limited partnership. New Texas Co.'s 1% of ABC Corp stock will be converted into a 1% general partnership interest. The Texas limited partnership will elect to continue to be taxed as a corporation for federal tax purposes.

This restructuring strategy accomplishes the same result as the asset drop-down strategy. The business assets are owned and operated by a limited partnership that does not pay franchise tax. One percent of the profits and losses are owned by a general partner entity that provides liability protection for its members; this 1% will be subject to Texas franchise taxes. Ninety-nine percent of the limited partnership interests are owned directly by the individual investors. The individuals will not pay Texas franchise tax.

The conversion will be a tax-free reorganization for federal tax purposes. The IRS has ruled that a state law conversion of a corporation into a limited partnership accompanied by an election of the limited partnership to be continued to be taxed as a corporation will qualify as an F reorganization under IRC § 368(a)(1)(F). PLR 199942009 (July 16, 1999).

The conversion statute in Texas has the added benefit of not requiring ABC Corp to retitle the property after the conversion. The ownership of the business assets are deemed by statute to be transferred to the new limited partnership automatically without the need for a conveyance document. Tex. Bus. Org. Code § 10.106.

One disadvantage of the conversion strategy is that the entity will be liable for an additional franchise tax upon its conversion. The Texas franchise tax statutes call for an Additional Tax to be assessed against a taxpayer when it is no longer subject to the earned surplus component of the tax. Because ABC Corp will be converting into a nontaxable limited partnership, it will be liable for the Additional Tax. The Additional Tax rate is 4.5%, and it is assessed against the net taxable earned surplus of the

[3] The same Comptroller Rule provides that acting as a general partner in a Texas limited partnership does create nexus with the State of Texas for franchise tax purposes.

[4] The Texas Comptroller has issued numerous letters approving this structure. One such letter can be found on the Comptroller's Star System at Document Number 9903584L.

corporation for the period beginning on the day after the last day of its preceding full accounting year and continuing through the date of its exit. Tex. Tax Code 171.0011.

C. Conversions with S Corporations

The conversion strategy should not be implemented with S corporations without extreme caution. The IRS initially ruled that an S corporation can convert into a state law limited partnership, elect to be taxed as a corporation, and still retain its subchapter S election. PLR 199942009 (July 16, 1999). According to the facts of PLR 199942009, the partnership agreement of the resulting entity in the conversion provided for "equal allocations of profits, distributions of cash from operations, and distributions upon dissolution." *Id.* Shortly after it issued this favorable ruling, the IRS announced that it would no longer issue rulings on whether conversions into limited partnerships created two classes of stock under federal law. Maintaining two classes of stock would violate the requirements for qualifying to make a subchapter S election.

The "test" for whether an entity has more than one class of stock is if "all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds." The partnership agreement in PLR 199942009 met this test. Some writers believe that the result in PLR 199942009 is correct and that limited partnerships with partnership agreements that provide for equal allocations, distributions of cash, and liquidating distributions should be able to maintain subchapter S status. *See* Bryan W. Lee, *Changing Form of Entity*, University of Texas School of Law 49th Annual Taxation Conference, October 24, 2001, Austin, Texas. Other writers believe that the fact that general partners are liable for partnership obligations under state law confers an "unequal" benefit to limited partners, and that, therefore, state law creates two classes of stock for limited partnerships. *See* Daniel G. Baucum, *Avoiding Texas Franchise Taxes Through Conversions*, State Bar of Texas Advanced Tax Law Course, September 20-21, 2001, Dallas, Texas. The IRS's reluctance to respond to this question leaves an open issue for conversions by S corporations.

VI. RESTRUCTURING FOR SALES TRANSACTIONS

Owners may consider restructuring the ownership of business assets, through either method outlined above, in preparation for a sale of the property. The owners may have originally organized in an entity form that was taxable under Texas franchise tax law because the annual gross receipts would allow them to take advantage of the Small Corporation Exemption. But now, upon the sale of the property, the entity will have gross receipts greater than $150,000, and the gain on the sale of the property will be subject to the 4.5% earned surplus component of the Texas franchise tax. By implementing a restructuring strategy simultaneously with the transaction, the company should be able to avoid paying Texas franchise taxes on the gain from its sale.

VII. CONCLUSION

Choosing the proper entity form is one of the first choices made by small business owners and investors. By addressing and considering the positive and negative attributes of each available entity form, the owners should be able to identity what type of entity best suits their business venture.

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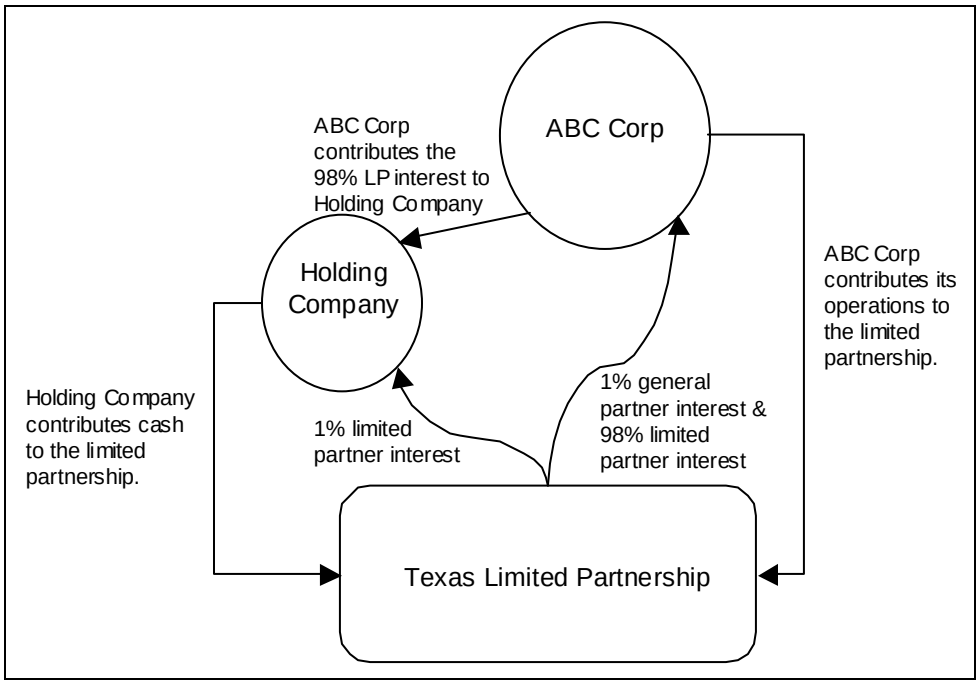
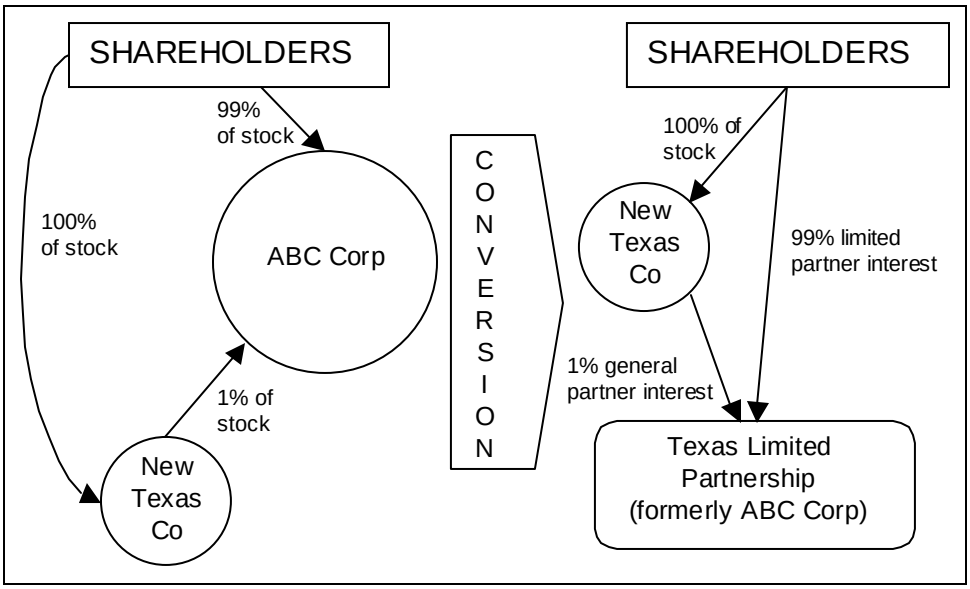
APPENDIX A

ASSET DROP-DOWN RESTRUCTURING



APPENDIX B

CONVERSION RESTRUCTURING



APPENDIX C

SUMMARY CHART

Entity Form	Taxation		Flexibility for Allocations & Distributions	Flexibility for Liquidations	Owners' Ability to Manage and Control	Owners' Personal Liability Limited	Statutory Protection from Owners' Creditors
	Federal	Texas Franchise Tax					
Individually	Pass-through; Must pay self-employment tax	NO	N/A	N/A	YES	NO	NO
C Corporation	Entity pays tax; Do not self-employment tax	YES*	NO	NO	YES	YES†	NO
S Corporation	Pass-through; Do not pay self-employment tax	YES*	NO	NO	YES	YES†	NO
General Partnership	Pass-through; Must pay self-employment tax	NO	YES	YES	YES	NO	NO
Limited Partnership	Pass-through; General Partners pay self-employment tax, Limited Partners do not‡	NO	YES	YES	General Partners—YES; Limited Partners—Subject to "Safe Harbor" activities	General Partners—NO; Limited Partners—YES;	YES
LLC—single member	Pass-through; Must pay self-employment tax	YES*	N/A	N/A	YES	YES†	Probably Not
LLC—multi-member	Pass-through; Do no pay self-employment tax	YES*	YES	YES	YES	YES†	YES
LLP	Pass-through; Must pay self-employment tax	NO	YES	YES	YES	Each partner liable for his/her own negligence only	Not clear

* Subject to the $150,000 Small Corporation Exemption.
† Subject to "piercing the corporate veil" arguments.
‡ Limited Partners must pay self-employment tax on guaranteed payments or payments for services provided to the partnership.