



## **DOING BUSINESS IN TEXAS:**

### **CHOOSING THE RIGHT BUSINESS ENTITY**

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One of the most important decisions a business owner makes is choosing the legal structure in which to operate. In Texas we have many business entities, each with distinctive attributes. The challenge for business owners is to choose the entity that will best suit current and anticipated future needs. Major factors to consider are: What kind of business do you have? What is your liability exposure? How many people are involved in your business? Are you planning for growth and expansion, or to maintain a constant size? What are tax and financial considerations for the business and for you personally? This article surveys common business entities in Texas to help you make your decision.

Sole proprietorship. The simplest and easiest to manage, sole proprietorships make up the majority of small businesses in Texas. As the name implies, sole proprietorships have only one owner. Sole proprietorships are attractive for several reasons. First, they do not require any formal filings with the State or any particular organizational documents. Establishing a sole proprietorship is as easy as coming up with a name for your business and registering that name as a DBA (doing-business-as) in the counties you will do business. Bank accounts and other business property should reflect the name of the DBA rather than the individual. Second, sole proprietorships are not taxed as a separate entity from the individual, rather, they are taxed as part of the owner's income on "Schedule C" of IRS form 1040. Third, sole proprietorships do not pay any state margin taxes. In addition, sole proprietors are considered self employed and pay self employment tax on the compensation they receive from the business. For 2008 the self employment tax rates are 15.3% (social security and medicare) on the first \$102,000 of compensation and 2.9% (medicare only) thereafter. Because sole proprietorships are not distinct from the owner, liability is not limited to the business, but instead flows to the proprietor as an individual. For example, the creditor of a sole proprietorship may look to the personal assets of the proprietor to recover a debt.<sup>1</sup> This is a major disadvantage of sole proprietorships.

Corporation. The complete opposite from the sole proprietorship is the corporation. Corporations are separate legal entities from the individual(s) who own them. Contrasted with sole proprietorships, corporations are subject to strict legal requirements to create and operate them, such as filing a Certificate of Formation with the Secretary of State and the observance of corporate formalities. For example, a corporation must have shareholders (owners), directors

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<sup>1</sup> Texas law exempts certain personal property from creditors, such as homestead. These items are still protected assets if a judgment is obtained against a sole proprietorship.

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(the ones with strategic decision making authority), and officers (the ones who see that the day-to-day functions of the corporation are achieved in accordance with the directives of the directors). Corporations enjoy the benefit of limited liability -- meaning the owners (shareholders) are not responsible for the debts and other liabilities of the corporation. The limited liability feature and the ability to accommodate businesses of varying sizes and needs are the most attractive aspects of corporations. As separate legal entities, corporations pay federal income tax and state margin tax. Shareholders who also work for a corporation do not pay self employment tax, but rather are considered employees and the corporation is required to withhold federal and state taxes as part of payroll.

S Corporation. The S Corporation is thought of as a corporation for small businesses. The difference between an S and a C corporation is mostly a matter of federal income tax law that allows small corporations that meet certain criteria to elect to be taxed at the individual level, rather than at the corporate level. (Contrary to common belief, the “S” designation does not refer to “small” but instead to the subchapter of the Internal Revenue Code that allows the tax election.) This tax treatment is called “pass through” because the tax on the S corporation is passed through to the owners and reported on their individual income tax returns. For most other purposes, however, S corporations are the same as C corporations, and Texas laws pertaining to corporations apply equally to S and C corporations, including the need to file a Certificate of Formation, the shareholder/director/officer hierarchy, the observance of corporate formalities, the limited liability benefit, and payment of state margin tax. Limits on S corporations include who can be a shareholder (natural persons and some trusts; no resident aliens), no more than 100 shareholders, and only one class of shares. Many small businesses choose S corporations to take advantage of the limited liability protection and pass through tax features. An S corporation may have only one owner, and that owner is considered an employee of the company.

Partnerships. In its oldest and simplest form, a partnership has features similar to a sole proprietorship, except there must be two or more persons involved. Partnerships do not require any formal filings, and in fact do not even require a written partnership agreement. All income and loss is passed through to the individuals who make up the partnership. Partnerships are also not subject to state margin tax. While partnerships offer organizational ease and few operational restrictions, there is no protection from liability. In other words, the liabilities of one partner become the liabilities of the other partners, even if the other partners were completely unaware and uninvolved in the acts that gave rise to the liability. Because of the exposure to liability, this type of partnership is the least favorable type of business entity.

Limited Liability Partnerships. Limited Liability partnerships (“LLPs”) combine many advantages of partnership with the protection of limited liability, and are a popular choice for professional service firms. Two or more parties are required to form an LLP, and except for each partner's own errors and omissions, partners are protected from liability for the acts of the



partnership and the other partners. In contrast to limited partnerships, discussed below, all partners in an LLP have equal rights to participate in the management of the partnership. Federal income tax is passed through to the partners. As of January 1, 2008, LLPs are subject to the state margin tax. LLPs must register with the Secretary of State each year for a fee of \$200 per partner. Partners in LLPs are treated as self employed, not as employees.

Limited Partnerships. Limited partnerships must have a general partner and at least one limited partner. The general partner is liable for all liabilities of the partnership, while the limited partners have protection from liability, usually to the extent of their initial investment. Limited partnerships must be registered with the Secretary of State's office, at a fee of \$750.00. The tax treatment of limited partnerships is pass through to the partners, and there are limits on the limited partners' involvement in the management and control of the partnership. Because the general partner has unlimited liability, it is common for the general partner to be a liability-shielded entity rather than an individual. A Corporation (C or S) or an LLC is a good choice for the general partner. Limited partnerships pay margin tax, as of tax year 2007.

Limited Liability Company. Limited liability companies ("LLCs") offer the ultimate in flexibility for business entities. LLCs are a hybrid of partnerships and corporations, and the newest type of business entity. An LLC requires filing a Certificate of Formation with the Secretary of State for \$300.00 and is subject to Texas margin tax. An LLC is governed by its Company Agreement (formerly "Regulations"), which may be similar to corporate bylaws or to a partnership agreement, depending on the desires of the owners, called members. An LLC may elect to be treated as a partnership for federal income tax purposes (pass through to members) or as a corporation. The members of LLCs have limited liability, and all may participate in the management and control of the company. LLCs may be run by members or managers, and may have multiple classes of members, as determined in the LLC documents.

A precaution about limited liability. As you can see, most of these business forms include limited liability for the business owners, one of the most valuable features available to modern business entities. However, an important corollary to limited liability exists: to enjoy the benefit of protecting your personal assets from your business liabilities, you must maintain the separateness between business assets and liabilities and personal assets and liabilities, and comply with applicable laws on point. Failure to do either may result in "piercing the corporate veil," a legal doctrine that says you don't get the benefit of limited liability protection if you do not observe the laws that govern the entity. Once the corporate veil is pierced, the liability protection is disregarded, meaning your business creditors may satisfy business debts from your personal assets.



A note about the Texas margin tax. Texas imposes a margin tax on virtually all business entities except sole proprietorships and partnerships in which all partners are natural persons (humans). Margin tax is only due if the company has total revenue over \$300,000 in a calendar year, and there are concessions for small and medium-sized businesses. The margin tax is calculated on the lesser of three formulas: 70% of your total revenue, total revenue minus cost of goods sold, or total revenue minus cost of compensation. The tax rate is .5% if you are a retail/wholesale business and 1% for all other businesses. The concessions for small and medium-sized businesses are a discount on the tax rate if total revenue is less than \$900,000 and a simplified computation formula.

The discount applies as follows:

<u>Total revenue</u>	<u>Discount</u>
0- \$300,000	100% (no tax due)
\$300,001 - \$399,999	80% (pay 20% of tax due)
\$400,000 - \$499,999	60% (pay 40% of tax due)
\$500,000 - \$699,999	40% (pay 60% of tax due)
\$700,000 - \$899,999	20% (pay 80% of tax due)

The "E-Z computation" can be used by any entity if total revenue is not more than \$10 million. The E-Z computation does away with the cost of goods sold or compensation deduction, and instead there is a flat tax rate of .575 percent.

You should consult with your tax advisor for specific advice on the margin tax. Additional information is also available on the Comptroller's web site: <http://www.window.state.tx.us/taxinfo/franchise/margin.html>.

A note about employment taxes. Federal and state employment taxes are payable regardless of the business entity you choose. The owners of sole proprietorships, all types of partnerships, and LLCs that are taxed as partnerships are subject to self-employment tax. The owners of Corporations (C and S) are subject to employer payroll taxes for money received as salary and bonuses, but not for money received as shareholder distributions/dividends. You should consult with your tax advisor to determine the implication of employment taxes for the different types of business entities.

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