CHOOSING A BUSINESS ENTITY IN TODAY'S BUSINESS WORLD

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The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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A. INTRODUCTION.

Not all that long ago, choosing a business entity used to be a relatively painless process. If you wanted limited liability you incorporated; and if limited liability was not important, you operated as a sole proprietorship or a general partnership. In a relatively short period of time, state and federal tax law changes along with the advent of new types of business entities have made the choice of entity a much more difficult and, in many respects, a much more important, decision for would-be business owners. Today the menu of business entities from which to choose is quite lengthy: a sole proprietorship, a general partnership, a limited partnership, a C or S corporation or a limited liability company; furthermore, certain entities offer various "extras" in certain situations, such as registering as a limited liability partnership or choosing to operate as a professional corporation or limited liability company. The choice will vary from state to state based upon the liability and tax considerations peculiar to each state. While the vast majority of businesses are operated in one of three forms, i.e. a corporation, a limited partnership or a limited liability company, most of the time, there is no absolute right or wrong answer. The circumstances of the business owners, their goals and desires and their long term plans all play a role in deciding which type of entity is the best for the business owner or business owners.

The choice of entity can vary depending upon the activity to be undertaken by the business owner. In certain industries, i.e. real estate, the use of limited partnerships is very common and accepted by third parties you would be dealing with in your business. In other industries, a corporation is the preferred entity in which to operate because of the familiarity of corporate form to investors, suppliers, customers and other third parties. In some situations, the business owner may want to transfer a substantial amount of the equity to family members while still maintaining control. While the limited partnership can be easily structured to satisfy this arrangement, with proper drafting, the limited liability company can also be utilized to accomplish this objective. In any event, prior to implementing the business strategy, business owners should consult with a lawyer familiar with all types of entities. Additionally, the business owner should make sure there is good coordination between his legal counsel and his accountant regarding the entity, the planning and the long term goals of the business owner. Only through proper coordination between all the advisors, will the business owner receive the best possible advice. Finally, this outline is not intended to be comprehensive, addressing all of the issues of each entity. To do so would be impractical and would be more confusing than enlightening. This outline is intended to provide a listing and brief discussion of many of the major issues in choosing an entity. Each business owner's situation is unique and the choice of entity in each situation can only be determined after understanding all of the goals and plans of the particular owner.

B. TYPES OF BUSINESS ENTITIES.

1. *Sole Proprietorships.*

a. Overall. Generally, a sole proprietorship is a business operated by a single individual without the benefit of any other independently created business entity. Many "mom and pop" businesses are typically reported as sole proprietorships even though more than one owner is involved in the operation of the business. There are other business entity types that deal with direct ownership and involvement of the business that are frequently understood to be similar to a sole proprietorship. These include undivided interests in property, co-ownership or joint ownership of property, or other similar arrangements. Additionally, a single owner LLC is treated as a sole proprietorship for federal income tax purposes unless an alternative election is made by the owner. (See Section 4 below)

b. Practical Operational Issues. Operationally, a sole proprietorship normally operates under an assumed name, with a bank account utilizing the owner's individual social security number. No state law filings are required (other than necessary for the assumed name certificate) and all contracts and obligations are the individual responsibilities. The business owner is personally liable for all debts and obligations (including tortious and negligent acts of employees) of the sole proprietorship. No protection is provided for the business owner's personal assets other than any protection afforded through business liability insurance. It is the simplest of the operational forms but also the form with most risk in terms of liability from its operations. It would only be recommended for a business owner with limited personal assets that would be placed at risk from the business operations.

c. Tax Issues. The sole proprietorship operates under the social security number of the business owner. A separate tax return is not required for the sole proprietorship but instead all income and losses are reported on Schedule C on the business owner's individual income tax return. One of the major concerns of the IRS in auditing sole proprietorships is unreported income and the deduction of individual personal expenses which are not business related. Income of a sole proprietorship is not subject to the Texas Margin Tax, but all income received by the sole proprietor that is also classified as "self-employment income" under federal tax law is subject to self-employment tax.

2. *General Partnership.*

a. Overall. A general partnership is just a step removed from a sole proprietorship. In other words, a general partnership could be viewed as a collection of sole proprietorships. A general partnership is basically a collection of individuals or entities operating together to produce a profit through a business enterprise. The only difference between a general partnership and a sole proprietorship is that a general partnership is normally operated pursuant to a written general partnership agreement among the partners outlining the terms of their agreement for sharing profits and losses, management, dissolution and transfers of partnership interests (although a written partnership agreement is not required to form a general partnership in Texas). To the extent these types of matters are not addressed in a partnership agreement, each state has enacted statutory laws to provide an overall structure for the management and operation of the general partnership.

b. Practical Operational Issues. As with the sole proprietorship, the general partnership is not a preferred entity to be used by individuals because each partner will be jointly and severally liable for debts and obligations of the general partnership. This means that Partner A will be liable for the acts of Partner B as well as the acts of the employees of the partnership, i.e. car accident, sexual harassment, discrimination, etc. This causes the individual business owner to be personally at risk for the operations of the partnership.

General partnerships are the easiest entity to set up and dissolve among multiple owners. No state law filing is required to set up a general partnership. In fact, you could have an oral general partnership based upon the agreements of the parties. As stated above, no written agreement is required to run a general partnership. It is always recommended, however, that a written general partnership agreement be put in place in order to have a clear understanding among the partners of: (1) their ownership interest; (2) their sharing of profits and losses; (3) their obligation to contribute additional capital; (4) the sharing of management among the parties; (5) the ability of a partner to withdraw from the partnership or to cause a dissolution of the partnership; (6) the restrictions on transfer of partnership interests; and (7) the ability to incur debt or other liabilities for the partnership. No business owner should enter into a general partnership without clearly understanding the liability risk, the investment obligations, and the management structure.

c. Tax Issues. For federal income tax purposes, the income and losses of the general partnership flow through to the partners based upon their profit and loss sharing ratio as set forth in the agreement. A general partner will be able to deduct losses to the extent of his outside basis in his partnership interest, which will include his share of any debt of the partnership. Any income that flows through to the partner will be subject to self-employment tax at the partner level if the partnership's income from operations would have qualified as self-employment income. Partnership income tax law is probably the most complicated area of the federal income tax laws. This complication is a blessing and a curse for the unaware; the partnership tax rules can be a trap and cause recognition of income unanticipated by the partner. However, the complexity of the partnership tax law also provides for great flexibility and benefits to the informed business owner. Some of these benefits include innumerable methods of structuring special allocations of profits, losses and cash distributions, the use of a "profits interest" to provide equity to key employees without triggering income tax on receipt of the equity interest, the ability to use partnership debt to increase the outside basis of the partner in order to deduct losses in excess of the contribution amount of the partner and other tax beneficial arrangements. Due to the aggressiveness of many practitioners in the past fifteen years in stretching the partnership tax rules to the extreme, Congress has consistently modified the tax laws to try to curtail what they view as abusive or sham transactions. Any business owner who is attempting to take advantage of the partnership tax rules should receive clear advice from a practitioner familiar with the partnership tax laws and then should have that advice coordinated with his CPA in order that all of his advisors understand the structure and the plan. A general partnership is subject to the Texas Margin Tax unless all of its owners are natural persons or the partnership falls under certain limited exceptions to the tax.

3. ***Limited Partnership.***

a. Overall. The limited partnership has received tremendous publicity in the last fifteen years because of its use in the family planning area to transfer wealth at a discounted rate. In fact, the limited partnership has been used for a number of years in the business setting because of the flexibility of its tax arrangement (See Section 2 above), the fact that it previously was not subject to Texas franchise taxes, and the ability, if properly structured, to have liability protection for the ultimate owners of the limited partnership. A limited partnership will be structured with one or more general partners and one or more limited partners. The general partner or general partners will have control of the day-to-day operational aspects of the partnership and any other matters allowed the general partner as set forth in the Limited Partnership Agreement. In almost all cases, the general partner is a corporation, limited liability company, or another limited partnership because the general partner is ultimately liable for all of the debts and obligations of the limited partnership. To keep this liability from flowing through to the individual owners, the general partner is almost always an entity. The limited partners can be individuals or other entities because they do not have liability for the operations of the limited partnership unless they participate in the management of the business in their capacity as a limited partner. A limited partner participating in the management of the limited partnership as an employee of the partnership or an employee of the general partner will not cause the limited partner to be liable for the debts and obligations of the limited partnership. State law has been expanded to allow a limited partner to participate in multiple actions related to the partnership without causing the limited partner to be liable for the debts and obligations of the limited partnership, i.e. become a general partner. In fact, state law in Texas says that a limited partner will not be liable for the acts of the partnership with a general partner as long as the acts he has undertaken on behalf of the limited partnership are set forth in the limited partnership agreement. The major negative in operating a business entity as a limited partnership is the additional cost in the setup, as the limited partnership will normally involve at least two entities, i.e. the limited partnership itself and an entity as the general partner.

b. Practical Operational Issues. A limited partnership is a state created entity and in order for the limited partners to receive liability protection, the limited partnership must file a Certificate of Formation with the State of Texas. Business owners can come together and sign a limited partnership agreement, but if the entity does not file a Certificate of Formation, then for state law purposes, it is considered to be a general partnership. All limited partnerships should have a limited partnership agreement which clearly sets out the rights and obligations of the partners, including the responsibilities of the general partner and the matters upon which the limited partners will have control or a vote regarding the operations of the limited partnership. The structure of the limited partnership is very flexible and can provide that the general partner will have control over almost all of the operational aspects of the limited partnership with the ability to only be removed "for cause." In this fashion, a 1% owner, a ½% owner or even a 0% owner, i.e. the general partner, could control the operations of the limited partnership as a whole, even though it only has minimal or no ownership. This aspect of the limited partnership planning has been very favorably received for years for promoters who want to control the operation of a business entity in which they retain outside investors even though they have minimal capital risk. It has also been popular with the elder family members who wish to retain control of the business operation while transferring equity to succeeding generations. The limited partnership is a sophisticated planning tool which can be structured to accomplish a number of the goals of the business owner.

c. Tax Issues. Like the general partnership, the limited partnership is a flow through entity, as all income and losses flow through to the partners based upon their profit and loss sharing percentage set forth in the limited partnership agreement. The partnership itself does not pay any federal income taxes, although it does file a federal income tax return evidencing its income and the flow through of the income to its limited partners. One advantage of the limited partnership is that the income that flows through to its limited partners is not normally subject to self-employment tax like it is in a general partnership or in certain circumstances in a limited liability company. Subject to certain exceptions, limited partnerships are subject to the Texas Margin Tax. Finally, as discussed above regarding general partnerships, partnership tax laws provide great flexibility to the business owners to accomplish certain tax planning designs not available for corporations.

4. ***Limited Liability Company.***

a. Overall. The limited liability company ("LLC") is an entity that has grown in popularity and has become more and more familiar to the business owner and legal and accounting practitioners. The LLC was originally enacted as a hybrid entity that actually combines the features of a corporation and a partnership. It is a single entity in which all of its owners (called members) have liability protection from the operations of the LLC. However, for federal income tax purposes, it is treated as a partnership (unless an election is made to be taxed as a corporation). So therefore, it combines the benefits of the limited liability of the corporation for all of the owners of the LLC while retaining the tax advantages of a partnership. This has caused it to be the entity of choice in most states.

The members can have the power to run the day to day operations of the LLC or they can provide for managers to run the day to day operations of the LLC. Managers are similar to the Board of Directors of the corporation and operate in a similar fashion.

b. Practical Operational Issues. An LLC is a state created entity which means that you must file a Certificate of Formation to obtain the benefit of limited liability company status. Instead of Bylaws, the LLC normally has an operational document called a Company Agreement which is a hybrid of Bylaws (corporation) and a Partnership Agreement (partnership).

The operational aspects of LLCs are very flexible under the Texas law. Unlike corporations which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual Board of Director meetings, election of officers, evidence of authorization of corporate act, minute books, etc.), LLCs require much less with regard to "maintenance" of the entity. Whereas in a corporate situation, the Board of Directors must elect officers in order to bind the corporation to any act or obligation, an LLC's managers are able to bind the LLC directly and do not have to elect officers. Furthermore, LLC law is very liberal with respect to the evidencing of consent to authorize a manager to bind the company. Whereas a corporation must show appropriate resolutions, meeting minutes or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence the particular person's authority to act on behalf of the LLC. Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple oral representation. Furthermore, LLC members and managers are not required to have annual meetings. These attributes cause the LLC to be a very attractive form of business especially for those who desire a low maintenance option to the rigidities of corporate law.

Another advantage that the LLC (and the limited partnership) has over the corporation is the treatment of judgment creditors of each entity's owners. Specifically, a judgment creditor may attach a debtor's stock in a corporation in order to satisfy its claim against the debtor. If this action occurs, the judgment creditor assumes the stock and also assumes the role as a shareholder in the company with all rights that belong to such shareholder including voting and all accompanying rights of distribution. In other words, the other shareholders of the company run a danger of becoming the unwitting co-shareholders with the judgment creditor. Under Texas LLC law (and Texas limited partnership law), it appears that a judgment creditor who attempts to attach an LLC interest owned by a debtor can only obtain a charging order giving the judgment creditor the right to receive distributions to which the judgment debtor would otherwise have been entitled in respect of the debtor's ownership interest. It does not appear that the judgment creditor obtains any other rights of ownership such as voting on any matter of the LLC (or LP). This includes the decision of the LLC (LP) to make distributions in the first place. While the judgment creditor would have the right to any distributions made, the judgment creditor would not have any control over whether such distributions were made. This makes the LLC interest (or LP interest) somewhat unattractive as an asset for creditors and encourages the judgment creditor to seek satisfaction of its obligation owed to it by attaching other assets of the debtor and significantly reduces the chances that other co-owners of the LLC (or LP) having to go into business with a creditor of a co-owner.

c. <u>Tax Issues</u>. An LLC can be classified as a sole proprietorship, a partnership or an association for federal income tax purposes. A single member LLC is classified as a sole proprietorship for federal income tax purposes and no federal income tax return is filed for the LLC. Instead all income and deductions of the LLC are reported on Schedule C of the sole owner. Therefore, while the single owner has limited liability, he receives the benefit of less complexity as he or she does not have to file a separate federal income tax return for the LLC.

If there are two or more owners of the LLC, then the LLC is treated as a partnership for federal income tax purposes unless the owners elect to be treated as an association (i.e. a corporation). Being able to be treated as a partnership for federal income tax purposes is advantageous to an LLC in that it allows it to take advantage of the flexibility in the partnership tax area discussed above, while still retaining limited liability for all of its owners in a single entity. However, there are disadvantages in the tax area to LLCs that each prospective business owner must be aware. To the extent the members/managers of the LLC are involved in the operations of the LLC (or if there are no managers, the members are involved in the operations of the LLC) the IRS has proposed regulations which provide that the flow through income of the LLC may be subject to self-employment tax for the member/managers or members who are involved in operations. Unlike the S corporation, C corporation or limited partnership, where only compensation income is subject to employment taxes, these proposed regulations subject flow through income to the parties involved in management to self-employment tax, even though the income is clearly beyond the normal amount that would be paid for compensation. While Congress initially voiced disapproval over the Service's proposed regulations and indicated it would enact legislation to resolve the issue and equalize treatment in this area among limited partnerships, LLCs and S corporations, no action has been taken as of this time by Congress. Furthermore, the moratorium period placed by Congress on the Service (directing the Service not to make the proposed regulations final) has passed. While the Service is presumably free to make its regulations final, the assessment by many practitioners and academics is that the Service is going to wait until Congress acts on the issue before making any decisions. Therefore, the prospective business owner must be clearly aware of the self-employment tax implications of his or her ownership in the LLC if he or she is also going to be involved in the operations. LLCs are subject to the Texas Margin Tax and are not able to qualify as a "passive entity" similar to a limited partnership in order to avoid application of the Texas Margin Tax.

5. *S Corporations.*

a. Overall. An S corporation is a corporation formed under state law by filing a Certificate of Formation. The shareholders then make an election with the IRS to be taxed as an S corporation for federal income tax purposes which will cause all income and deductions of the corporation to flow through to the shareholders based upon their stock ownership. An S corporation is a federal tax law classification and therefore, in order to qualify and elect to be an S corporation, the business owners must satisfy the federal income tax rules attributable to it. This includes limiting the number of shareholders (no more than 100) and the type of shareholder who can own S corporation stock (U.S. citizens and resident aliens, estates, certain trusts and another S corporation provided it owns 100% of the subsidiary S corporation). Additionally, the flexibility of multiple classes of stock is not available, as S corporation rules require there only be one class of stock. However, the S corporation rules do allow differences in voting rights, thereby allowing you to have a class of voting stock and nonvoting stock. Certain debt instruments that have equity features can be considered as separate class of stock and can cause the loss of S corporation status.

b. Practical Operational Issues. An S corporation is a regular corporation for state law purposes. In order to form the corporation, the business owners must file a Certificate of Formation with the Secretary of State's office. As with limited liability companies, the owners, i.e. shareholders, are not subject to the debts and obligations of the corporation unless they have otherwise agreed to become obligated for such debt, i.e. personal guarantees. State law regarding the operation and management of corporations is well established and provides a fairly clear operational structure for the entity. An S corporation is subject to Texas Margin Tax.

S corporations are subject to very technical, unforgiving rules of federal income tax law regarding the qualification and maintenance of S corporation status. If an S corporation was previously a C corporation, there could be tax issues related to built-in gains tax, or passive investment income tax issues. Changes of ownership to nonqualified S corporation shareholders can terminate the S corporation status and cause future adverse tax consequences. The shareholders of the corporation have the ability under state law to enter into shareholder agreements to document certain operational control issues, succession planning and buy-sell arrangements. This flexibility allows the shareholder to document unusual business agreements in a manner that will be enforceable on all the parties. The advantages of the S corporation are that it is a single entity providing liability protection for its owners and it is a state law corporation with which most parties are familiar.

c. Tax Issues. Normally, an S corporation is not subject to corporate income tax as all gains and losses flow through to the shareholders based on their stock ownership. However, an S corporation that previously operated as a regular (C corporation) corporation could be subject to certain taxes at the corporate level, i.e. built-in gains tax and passive investment income tax. Any business owner of an S corporation that previously operated as a C corporation should seek legal advice regarding the impact of these corporate level taxes on his or her operations. Unlike an LLC, the income that flows through to its shareholders is not subject to self-employment tax under the IRS's proposed regulations. For many years, small business owners would pay themselves small salaries and then pull out their profits through S distributions to avoid paying FICA taxes on the majority of what normally would be wages. In recent years, the IRS has begun to review this issue more closely and require the business owner to take out a reasonable salary. However, to the extent that the business owner makes distributions to himself or herself above the reasonable compensation amounts, these amounts will not be subject to self-employment tax. Finally, in most situations, a partnership and an LLC are able to distribute their assets out to the owners without triggering tax at the entity level. An S corporation, however, will be required to recognize gain on any assets distributed to its shareholders, whether such distribution is a liquidating or nonliquidating distribution. This means that if the S corporation distributes assets to the shareholders, it will recognize income at the S corporation level that will flow through to the shareholders based upon their ownership percentages. While such distributions by the S corporation will not cause the full double tax that a C corporation would incur (see below), the recognition of gain at the corporate level reduces the planning opportunities in an S corporation thereby providing less flexibility and tax planning as compared to the partnership and LLC. The S corporation is subject to the Texas Margin Tax.

6. *C Corporations.*

a. Overall. A C corporation is a regular corporation created under state law just like the S corporation. The difference between the C corporation and the S corporation is that the shareholders did not elect for the corporation to be taxed as an S corporation, thereby not causing all the income and losses of the corporation to flow through to its shareholders. In other words, if the shareholders decide not to make (or fail to make) an "S corporation" election with the IRS, the corporation, by default, will be treated as a C corporation for federal income tax purposes. A C corporation is its own taxpayer (i.e. separate taxpaying unit) and is responsible for corporate level tax on all of its income. The operational issues and other matters are, for state law purposes, identical to an S corporation. A C corporation is liable for Texas Margin Tax and there are no self-employment taxes on any dividend distributions by the C corporation to its shareholders. Prior to 1986, a C corporation was the preferred entity for most business owners. However, in today's business world, very few closely-held corporations operate as C corporations anymore because of the double tax nature of the entity, i.e. corporate profits are taxed at the corporate level, and any distributions (i.e. dividends or liquidating distributions) to the shareholders, other than compensation, are again taxable at the shareholder level. C corporations are very disadvantageous on a sale of the corporations business, as most buyers want to buy assets not stock. An asset sale causes full double taxation to the shareholders if they want to receive the proceeds of the sale, i.e. a corporate tax at the C corporation level on the gain on the corporation's sale of its assets and an individual tax at the shareholder level based upon the proceeds received by the shareholders in liquidation over the tax basis in the shareholder's stock.

b. Practical Operational Issues. The operational issues for a C corporation are very similar to an S corporation for state law purposes. In most situations C corporations today are only used when the owners of the entity are not qualified S corporation shareholders and the entity was set up prior to the availability of the LLC law. Additionally, venture capital investors and entrepreneurs who plan on growing the company to go public prefer the C corporation structure in order that they can insure that all profits are reinvested in the corporation to build and grow value so that they can cash out at capital gains rate upon sale.

c. Tax Issues. As discussed above, the C corporation is not a favored entity for federal income tax purposes due to its double tax nature. Because of this, very few entities formed today are structured to be a C corporation.

C. CONCLUSION.

Taxes, liability protection, and other considerations have caused the choice of business entity by a new business owner, or an existing owner, to be an issue requiring competent advice from the business owner's lawyer and accountant. Only after understanding all of the goals and plans of the business owner, both short term and long term, can a business owner's advisors recommend to him or her the proper entity for their business operations. This outline is intended to raise the issues for a business owner to consider – not to provide answers. Only after a thorough analysis and review can the answers be provided by the business owner's advisors. Good luck on your selection.

APPENDIX A

<u>Organizational Entity Chart</u>

CONSIDERATIONS IN MAKING THE CHOICE OF BUSINESS ENTITY

	Sole Proprietorship	**General Partnership**	**Limited Partnership**	**LLC**	**S Corporation**	**C Corporation**
Number of Owners	1	At least 2.	At least 2 (including 1 general partner and 1 limited partner)	At least 1 (Need at least 2 to be considered a partnership for federal tax purposes.)	1 to 100.	At least 1
Limited Liability for Owners	No	No, unless Partnership registers as LLP.	General Partner: No, unless Limited Partnership registers as a LLP. Limited Partner: Yes, other than amount invested.	Yes, other than amount invested.	Yes, other than amount invested.	Yes, other than amount invested.
Levels of Federal Income Tax	One Entity level: N/A Owner level: Yes	One Entity level: No Owner level: Yes	One Entity level: No Owner level: Yes	One Entity level: No Owner level: Yes	Generally: One. Entity level: No, except entity level tax if a former C corporation and too much passive income or built-in gains under Section 1374 and 1375. Owner level: Yes	Two Entity level: Yes Owner level: Yes, to the extent Corporation pays dividends to shareholders.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Classification for federal income tax purposes	Sole Proprietorship	Partnership (default)	Partnership (default)	1 Single member: a. Default: Disregarded as an entity separate from owner (i.e., sole proprietor) b. Election: S-corporation or C-corporation 2 Multiple members: a. Default: Partnership b. Election: S-corporation or C-corporation	Corporation (must timely file IRS Form 2553 and meet other IRS requirements for S-corporation status).	Corporation
Self Employment Tax on Individual Owner	Yes	Yes	General Partner: Yes Limited Partner: No (other than guaranteed payment for services).	Maybe	No, but reasonable compensation should be paid to shareholder active in the business. Caution: Excessive distributions to shareholder without reasonable salary may be recharacterized as compensation.	No, but reasonable compensation should be paid to shareholder active in the business. Caution: Excessive compensation to shareholder may not be deductible to Corporation and recharacterized as a dividend.
Texas Margin Tax	No	Yes, unless all direct partners are natural persons without liability protection OR the entity is a “passive entity”	Yes, unless the entity is a “passive entity”	Yes	Yes	Yes

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Types of Owner	No restrictions	No restrictions	No restrictions	No restrictions	Ownership is limited to individuals who are U.S. Citizens and residents and to certain U.S. trusts (i.e. grantor trust, QSST, or ESBT). No entity may be an owner (except S corporation which is 100% owner OR a single member LLC that is disregarded for federal tax purposes OR certain exempt organizations).	No restrictions.
Classes of Ownership Interests	One	Multiple classes are permitted	Multiple classes are permitted	Multiple classes are permitted.	Only one class of stock is permitted (i.e., can't have preferred stock). However, there can be differences in voting rights.	Multiple classes are permitted.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Voting Rights of Owners	N/A	Voting rights of owners are usually set forth in Partnership Agreement. To the extent the Partnership Agreement does not address voting rights of owners, Texas statutory law controls.	Voting rights of owners are usually set forth in the Limited Partnership Agreement. To the extent the Limited Partnership Agreement does not address voting rights of owners, Texas statutory law controls	Voting rights of owners are usually set forth in the Company. To the extent the Company Agreement does not address voting rights of owners, Texas statutory laws control.	Voting rights of owners are provided in Texas statutory law, as well as set forth in the Bylaws and Certificate of Formation. Board of Directors b. Mergers, conversion, sale of substantially all assets, dissolution/winding up c. Amendments of Certificate of Formation and maybe Bylaws. (voting rights may be modified by Shareholders' Agreement or Voting Agreement	Same as S Corporation
Restriction on Ownership of Subsidiaries	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions	No restrictions
Tax Year	Calendar	Generally calendar	Generally calendar	Generally calendar	Generally calendar	No restrictions
Organizational Filing Costs with TX SOS	N/A	None, unless LLP. LLP filing fee is $200 per Partner annually.	The filing fee for a Texas Limited Partnership is $750.	The filing fee for a Texas LLC is $300.	The filing fee for a Texas corporation is $300	The filing fee for a Texas corporation is $300.
Day to day management structure	N/A	Partners (default)	General Partner (default)	Members (if LLC is Member-Managed) or Managers (if LLC is Manager-Managed).	Board of Directors/ officers (unless other-wise provided in Shareholders' Agreement	Same as S Corporation

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Taxation of Contributions of Property to Entity	Nontaxable	Nontaxable unless disguised sale, violate investment partnership rules or the partner is relieved from debt.	Nontaxable unless disguised sale, violate investment partnership rules or the partner is relieved from debt.	Nontaxable unless disguised sale, violate investment partnership rules or the member is relieved from debt	Taxable, unless the transferors meet the 80% control test of IRC §351, in which case the transfer is nontaxable except to the extent of debt relief.	Taxable, unless the transferors meet the 80% control test of IRC §351, in which case the transfer is nontaxable except to the extent of debt relief.
Maximum Marginal Federal Tax Rate on Income from Business (Not including 3.8% Net Investment Tax, if applicable)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	39.6% (maximum individual rate)	Fluctuating corporate rate. Rule of thumb is 35% average rate. 20% for shareholder's receipt of dividends from corporation. If shareholder's tax rate is 39.6%, otherwise, 15%.
Special Tax Allocations of Income and Loss	N/A	Yes	Yes	Yes	No	N/A
Deductibility of Losses (and basis for entity-level debt) (subject to at-risk and passive loss rules)	Generally, no restrictions	A partner may deduct his allocable share of partnership's losses only to the extent of his tax basis in his partnership interest <u>which includes</u> his allocable share of partnership debt.	A partner may deduct his allocable share of partnership's losses only to the extent of his tax basis in his partnership interest <u>which includes</u> his allocable share of partnership debt.	A member may deduct his allocable share of LLC's losses only to the extent of his tax basis in his LLC interest <u>which includes</u> his allocable share of LLC debt.	A shareholder may deduct his allocable share of corporation's losses only to the extent of his tax basis in his stock (<u>which does not include</u> any portion of the corporation's debt) AND such shareholder's tax basis in his loans to the corporation.	Shareholders may not deduct any of the corporation's losses.

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Taxation of Cash Distributions	N/A	Nontaxable to the extent of a partner’s tax basis in his partnership interest.	Nontaxable to the extent of a partner’s tax basis in his partnership interest.	Nontaxable to the extent of a member’s tax basis in his LLC interest.	Nontaxable to the extent of the shareholder’s tax basis in his stock	Taxable as dividends to the extent of the corporation’s earnings and profits and then nontaxable to the extent of the shareholder’s tax basis in his stock.
Taxation of Distributions of Appreciated Property	N/A	Nontaxable	Nontaxable	Nontaxable	Taxable at corporate level (gain flows through to shareholder and increases stock tax basis). Taxable to shareholder if FMV of distributed property exceeds stock tax basis	Taxable to both corporations and shareholders.
Taxation Upon Liquidation	N/A	Nontaxable	Nontaxable	Nontaxable	Taxable at corporate level (gain flows through to shareholder and increases stock tax basis). Taxable to shareholder if FMV of distributed property exceeds stock tax basis	Taxable to both corporations and shareholders.
Section 754 Election to Adjust Inside Basis of Owner and Entity Upon Sale of an Owner’s Interest or Distribution of Property	N/A	Yes	Yes	Yes	No	No

	Sole Proprietorship	General Partnership	Limited Partnership	LLC	S Corporation	C Corporation
Charging Order as sole remedy of Judgment Creditor of Owner against Owner's Interest in Entity	N/A	Yes	Yes	Yes	No	No
Restrictions on Transfer of Owner's Interest in Entity (other than federal/state securities laws)	None	None unless restricted per Partnership Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a partner.	None unless restricted per Limited Partnership Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a partner.	None unless restricted per Company Agreement or other written agreement. Transferee has rights of an assignee only until admitted as a member.	None unless restricted per Certificate of Formation, Bylaws, Shareholders Agreement or other written agreement	None unless restricted per Certificate of Formation, Bylaws, Shareholders Agreement or other written agreement
Annual meetings/resolution, necessary for perpetuation of management	N/A	No	No	No	Yes (unless Share-holders' Agreement provides for perpetual management)	Same as S Corporation