TEXAS CREATES TWO NEW BUSINESS FORMS
IMPLICATIONS FOR STRATEGIC PLANNING

Charles R. B. Stowe
College of Business
Sam Houston State University
Huntsville, Texas

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The 1991 session of the Texas Legislature created two new forms of doing business in Texas. This paper reviews major elements of the new forms of doing business and the strategic factors that should be considered in deciding whether to use either form. Since both forms of limited liability companies are so new, there are definite risks in selecting either form from both the liability and tax perspectives. These risks extend from the fact that the forms are so new that there is no common law opinions interpreting the statutes. None-the-less, indications are that many organizations have filed for status as limited liability companies making this a topic worthy of consideration.

Strategic Considerations in Selecting a Form of Doing Business

There are four major strategic factors that should be considered in selecting a form of business. One factor is the need to obtain additional capital. The ability to finance an enterprise through borrowed money is limited because most lenders want collateral behind their loans. Lenders want to see that the owners of the business have risked their capital in the enterprise. Commercial bankers prefer a situation where not all the capital in a business has to be paid back with interest. That's why "equity capital" – money that investors have put into the business in exchange for a percentage of ownership actually permits a business to have more ability to borrow money. The selection of the proper form affects the ability of the investors to transfer their ownership to others (stocks are more easily transferable than partnership interests, for example).

It is theoretically possible that a sole proprietorship could be so successful that they do not have any need to raise additional capital. However, their owner might still opt to hold the ownership in a form other than a Sole Proprietorship just to limit their personal liability. Under respondent superior, the employer is liable for any torts committed by an employee while acting in
the scope of business. If the business is held as a sole proprietorship, the owner is personally liable for any judgments against the business. So, the second factor is the issue of liability and how to reduce the personal liability of the owners of the business.

A third consideration is the issue of taxation. When federal government takes anywhere from 15 - 33% of profits from a sole proprietorship and up to 48% from corporations, the issue of how to minimize taxes is important. The selection of a business form along with proper tax planning can result in the individual investors receiving a tax deduction for part of their initial investment (assuming the entity operates at a loss during its first year) and later arrange affairs so that when the entity starts earning a profit, the entity pays the tax bill instead of individual investors. The tax implications of the form of business may be crucial to both the owners and the investors. Texas has passed a "masked" form of a corporate income tax. Texas added a corporate franchise tax which is now calculated using both the income statement and the balance sheet. Other states have corporate income taxes that parallel more closely the federal corporate income tax. So, the impact of income-type taxes can add up to having the government as a "partner" who takes 22 - 60% of income!

A fourth consideration in selecting a form of doing business lies in the management structure and decision-making apparatus that each form entails. Some "mom and pop" corporations behave as though they are owned and controlled by their owners as a sole proprietorship. However, in selecting a form of doing business it is important to understand the costs and legal formalities that must be observed in order to maintain the "liability shield." In addition, the issue of control and what happens if the entity fails to meet the expectations of investors should be considered in the selection of the legal form of doing business.

The Tax Angle

There is a saying in business "Don't let the tax tail wag the economic dog." Good business decisions should be based on what makes sense for maximizing profit in a legal and ethical way. However, since Government is a major partner in any business from the fact that taxes can chop
off 15 - 55% of profit for taxes, it would be foolish to ignore the tax consequences when making business decisions.

Since the Tax Reform Act of 1986, the tax rates have been changed so that individuals are taxed at lower rates than corporations are. The individual tax brackets are 15%, 28% and approximately 33%. The corporate tax rate starts at 15% but takes a jump up to 48%. It may be advantageous for a business owner to have the ability to pay taxes based on the individual rather than the corporate rates.

The conventional forms of doing business: Sole proprietorship and Partnerships (either general or limited) permit "tax flow through benefits" meaning that the sales and expenses of the business are reported on the owner/investor's personal income statement. If the owner/investor is entitled to 32% of the profit, then that partner reports 32% of the profit on their tax form. The entity - the business - does not pay a tax directly to government like corporations do. A second advantage of the partnership format is that it is possible under tax law to allocate profits differently than losses! This makes the partnership a very attractive format for tax planning purposes.

The Liability Angle

So, why aren't all businesses organized as partnerships? The reason is that partners are individually liable for all the debts or judgments against the business. Say you have a partnership that owns a flower shop. Bonzo the delivery driver causes an accident and the flower shop is sued for $5 million. The injured plaintiff can collect from ANY partner! Well, what about forming the business as a limited partnership. The problem here is that the limited partners have very little say over the business. They don't "elect" directors of the corporation like corporate shareholders do. A second problem is that when you are a limited partner, the "evidence" of your ownership is not a deed or a share of stock, it is a contract signed by all the limited partners and the general partner. Such an instrument is not as easily transferred from one person to another just because it is a lengthy document and there is no formalized "stock market" or partnership exchange.
Two New Forms of Business

The Texas Legislature created two new forms of business that address the above concerns. Again, these forms are so new that many legal scholars are not completely certain that the courts will uphold all the characteristics built into the laws. It is too soon to tell if the courts will arrive at the same interpretation of the statutes as legal practitioners have interpreted them. So, by no means is this description a substitute for getting current legal advice when you start looking for a form a business.

L.L.P.

As previously noted, one of the disadvantages of forming a partnership is each partner is FULLY and INDIVIDUALLY liable for any debt or judgment (arising from a lawsuit) against the entity. The advantage of such a form is the "tax flow-through" benefit. The Limited Liability Partnership is a new form designed to address this problem.

The Texas Uniform Partnership Act Section 15(2) was amended to do away with joint and several liability arising from another partner's misconduct. The act reads:

(2) A partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence or malfeasance occurred, unless the first partner:
(a) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or
(b) had notice or knowledge of the errors, omissions, negligence, incompetence or malfeasance by the other partner or representative at the time of occurrence.

These provisions shield a partner from the type of liability exposure that makes being a partner so risky. The L.L.P. is available for any type of business or enterprise because there is no limitation in the statute creating this form.

The above quoted provisions also do away with partner liability under "respondent superior"! Recall that if an employee of a partnership causes an accident, the injured party may recover from
any partner. This statute restricts recovery to either the partner that committed the wrong or from the partnership entity - the business. But, the injured party cannot get a recovery from an individual partners' assets unless that partner was in some way responsible for the injury. Limiting a partner's personal liability is a major advantage of this new form.

Another advantage of this form is that the L.L.P. is a type of general partnership under Internal Revenue Service Regulations. Under Treasury Regulation Section 301.7701-2(a), as long as an organization does not possess two or more of the following characteristics, it will not be subject to the federal corporate income tax. We can state the regulation another way: If an organization has two or more of the following characteristics, it must pay a federal corporate income tax. The characteristics include: Continuity of life. The L.L.P. does not have continuity of life because it falls under state law under the partnership act which provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member would cause a dissolution of the organization. A second characteristic is Centralization of Management. This does not exist in an L.L.P. because each partner has the power to bind the partnership. Again, this provision is contained in the Texas Uniform Partnership Act. A third characteristic is limited liability such as that enjoyed by a shareholder of a corporation. While the Limited Liability Partnership does provide a shield against personal liability for certain acts, each individual partner is still liable for their own torts and the partnership is still liable for any torts or injuries caused by any of their partners or employees. So an L.L.P. does not have the limited liability for the purposes of federal income tax classification under Treasury Regulation Sections 301.77091-2 and 3017701-3. A fourth characteristic is the Free Transferability of Interest. Unlike a share of stock which any shareholder is theoretically free to sell or transfer to anyone (except for compliance with state and federal securities laws), the characteristic of free transferability of interest does not exist in a general partnership because each member can only transfer a right to receive profits without permission of the other partners. To transfer the right to manage and control the partnership, the prospective new partner must be admitted to partnership status through the consent of the other partners. An organization that abides by Texas law in claiming and operating under the Texas
Uniform Partnership Act as an L.L.P. does not have any of the characteristics that would require it to pay federal corporate income taxes.

The L.L.P. is also exempt from the Texas franchise tax. The franchise tax is a tax that is levied on all Texas corporations and corporations that are registered in Texas to do business. The franchise tax was changed from a fee based tax to a form of an income tax. Knowing that most Texans despise the idea of an income tax, legislators passed a law that taxes the "retained earnings" of corporations under the franchise tax laws.

Requirements to Start an L.L.P.

There are several requirements to starting an L.L.P. First, the entity must contain in its name the words "registered limited liability partnership" or the abbreviation "L.L.P." as the last words or letters of its name. Second, to gain the legal status of an L.L.P., the partnership must file an application with the Secretary of State of Texas and application with the fee of $100 for each partner. The application must state the name of the partnership, the address of the principal office, the number of partners (but not their names), a description of the business, and the application must be executed by a majority in interest (meaning a party or parties that are entitled to more than 50% of the profits). If these conditions are met, the L.L.P. registration is effective at the time of filing. Unlike corporations, there is no corporate charter or L.L.P. charter. A filed stamped duplicate of the application is all the evidence needed to claim L.L.P. status. The registration is effective for a year. A third requirement for L.L.P. status under the Texas Uniform Partnership Act section 15 (2) is that the partners must carry "if reasonably available at least $100,000 of insurance of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence or malfeasance for which liability is limited by ...". Under this provision, if insurance is not available, the defendant partner claiming a shield against personal liability has the burden of proving that such insurance was not available. This particular issue of whether insurance is available or not must be argued before the judge so that the jury will not know whether insurance is covering damages or not.
L.L.C.

The Texas Limited Liability Company Act created a new form of business called a limited liability company or L.L.C. The reason for creating this form of business has little to do with liability... it is a corporation in the sense that each owner is limited to the loss of their investment and no more. The reason for this form is "tax flow through benefits." The L.L.C. does not pay federal income taxes like regular corporations do. A sensible question is whether to incorporate and file under the Internal Revenue Service Code as an S Corporation. The difference between an L.L.C. and a regular corporation that has filed for S Corporation is that the L.L.C. does not have to meet the strict rules for claiming S Corporation status. Under the Tax Reform Act of 1986 Congress required that any corporation seeking S corporation status has to meet the following requirements. S corporations may only have one class of stock, be limited to 35 shareholders, have no corporations, non-resident aliens, general or limited partnerships, certain trusts pension plans and charitable organizations as shareholders, and an S corporation may not own 80 percent or more of the stock of another corporation. Another benefit of the L.L.C. status is that there is no IRS forms to use to "declare" S corporation status to obtain the flow-through tax status.

When compared with a L.L.P., the L.L.C. has some advantages and some disadvantages. An advantage is that an L.L.C. is not required to have a general partner who is liable for the partnership's debts as is the case in an L.L.P. If a shareholder of an L.L.C., called a "member" under the statute participates in the management of the business, that member is still shielded from personal liability unlike a partner in an L.L.P. who will be held liable for partnership debts if they exercise management control. However, a disadvantage is that this form is a type of corporation and therefore subject to the Texas franchise tax even though it is exempt from federal income taxes. A second disadvantage of this form is that it is uncertain as to whether other states will recognize the organization as a corporation with limited liability for the owners, or whether other states that do not yet have an L.L.C. statute will treat the organization as a partnership for the enforcement of judgments. One possibility for L.L.C. enterprises doing business in other states is for them to
register as a foreign corporation and pay the franchise tax. There are no cases on this point so enterprises doing business outside of Texas should consider the S corporation strategy.

**Starting an L.L.C.**

The procedures for starting an L.L.C. are very similar to the procedures used to start a corporation except that the vocabulary is quite different. Those forming an L.L.C. are referred to as "organizers" as opposed to incorporators. Instead of shareholders, owners of the L.L.C. are called members and directors are called managers. The procedure is to file Articles with the Secretary of State of Texas. The articles must specify the duration of the entity which may not exceed 30 years, the name and address of a registered agent and the names and addresses of the initial manager or managers. The name of the enterprise must contain a designation such as Ltd, Limited or L.C. Some legal commentators advise the use of L.C. because Ltd or Limited might confuse the public into thinking the entity is a limited liability partnership where one of the partners must be a general partner liable for all the debts of the entity. Unlike a regular corporation that has bylaws, the L.L.C. is not required to have "Regulations".

**L.L.C. Part Partnership Part Corporation**

In many ways an L.L.C. is an odd cross of a partnership and a corporation. It is like a corporation in that each owner or member has limited personal liability. The structure of the L.L.C. is fashioned after corporate law. L.L.C. has Articles to be filed with the Secretary of State. Under the Texas Limited Liability Company Act the owners of the entity called members have the right to vote for managers. These managers serve the function of a board of directors and have the right to hire officers. The L.L.C. may have but is not required to have a set of "regulations" similar to corporate by-laws. And the L.L.C. is subject to the Texas corporate franchise tax even though it is exempt from federal income tax.

In other ways, an L.L.C. is like a partnership. For example, the regulations are likely to look more like a partnership agreement than regular corporation's by-laws. This is because
L.L.C.s offer one other advantage over regular corporations. An L.L.C. may allocate profits and losses differently just like a partnership! Under limited partnership law, it is possible to arrange for limited partners to have the benefit of 99% of the losses which they can use as a deduction from personal income. Once the business starts making a profit or once the limited partners recover a certain percentage of their profits, the general partner backs in for a larger percentage of the profits. Prior to the 1986 Tax Reform Act, the ability to allocate profits and losses differently was a great a tax planning advantage. Many "deals" were promoted where the investors would get large deductions the first year (which reduced the effective cost of the investment) and hopefully they would receive their money back plus a profit in future years. The promoter gets capital and the promise of a high return without putting up any money for the risk! The 1986 Tax Reform Act dampened the use of partnerships as "tax shelters" because investors could only deduct $3,000 worth of losses maximum from "passive investments." Since most investors were limited partners, they were subject to a limitation on their deductions.

Another feature of L.L.C.s that makes it like a partnership is that a member may assign their membership interest in an L.L.C. but that assignment does not permit the buyer or creditor to assume the rights or powers of a member. This is very different from a share of corporate stock whereby the buyer of the stock automatically gets to vote those shares.

The language of the act dealing with the transfer of an ownership interest is very much like a partnership interest versus a corporate security. Like a partnership, the act provides that a member may resign at any time by giving written notice to the other members.

Conclusion

Texas is in the forefront of new business forms: the L.L.P. and L.L.C. It is apparent from the nature of the two new forms that they were designed to address two pressing problems facing businesses: liability of investors and owners, and taxes. A great area of uncertainty lies in whether other states that do not recognize these forms of business on their statutes will treat their owners/investors with limited liability. Nor is clear how other states that have corporate income
taxes will treat Texas entities that are L.L.P.s in terms of state income taxes. Probably for the moment, it would be strategically wise to only consider using these forms for entities that do all their business within Texas. Firms that have extensive tax and liability exposure outside Texas should resist. A second concern is that the law is so new that there are many questions as to how to maintain the necessary legal formalities for each entity. It is clear that even the accounting for ownership interests will have to evolve. There are Generally Accepted Accounting Principles for partnerships and for corporations, but in view of the differences in terms and rules, it may be necessary for the accounting profession to generate conventions or GAAP for L.L.P.s and L.L.C.s.

One group that has jumped on the L.L.P. bandwagon are law firms. The L.L.P. format permits tax savings by having the law firm's profits taxed at individual rates on each partners' individual federal income tax return rather than taxing a "Professional Corporation" at higher corporate tax rates. Many professionals use the professional corporation structure in an attempt to shield themselves from judgments arising from malpractice law suits against their partners. The major reason why many law firms switched from being partnerships to professional corporations is that attorney shareholders are only personally liable for their own malpractice and to the extent of their investment in shares of the firm. The L.L.P. form permits many "professional corporations" to be partners in an L.L.P. which means that each attorney who is a professional corporation can shield themselves from liability. The extent to which the L.L.P. and L.L.C. forms will be permitted to shield their owners from liability has yet to be tested by the courts. But, judging from the number of law firms who are reorganized as L.L.P.'s there is some heavy betting by the legal profession that these new forms represent promising strategies in an increasingly litigious society.

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** Associate Professor, College of Business Administration, Sam Houston State University