CHOICE OF ENTITY CONSIDERATIONS

CORPORATION?
LLC?
LLP?
PARTNERSHIP?
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CHOICE OF ENTITY CONSIDERATION

I. INTRODUCTION

One of the most important decisions entrepreneurs can make in establishing business ventures is the choice of entity. There are numerous factors, both tax and non-tax, that should be considered in selecting the right business vehicle. Below is a discussion of several business and legal issues that are critical to analyze in making a choice of entity determination.

II. TYPES AND TAXATION OF AVAILABLE ENTITIES

A. Partnerships

1. Types of Partnerships

The variety of partnerships, among others, includes general partnerships, limited liability partnerships ("LLPs"), and limited partnerships. A partnership may, and generally does, provide flow-through federal income tax treatment to all of its partners.3

2. Taxation of Partnerships

Partnerships are not taxed at the entity level for federal income tax purposes.4 Instead, all gains and losses flow through the partnership and are taxed at the partner level regardless of whether the income is actually distributed to the partners.5 The maximum rate of taxation for non-corporate and corporate partners is 35%.6

B. Limited Liability Companies

A limited liability company ("LLC") is an entity that is formed under U.S. state law that typically has some characteristics of a partnership and some characteristics of a corporation. If an LLC is classified as a partnership (or in the case of a single owner LLC, as a non-entity) for federal income tax purposes, it will provide flow-through federal income tax treatment for its members.7

1. Taxation of LLCs

a. Single Member LLCs

A single member LLC can be disregarded as an entity separate from its owner for federal income tax purposes.8 However, the member may elect to tax the LLC as a corporation under the "Check-the-Box" Treasury Regulations.9

b. Multiple Member LLCs

LLCs with more than one member can be taxed as a partnership for federal income tax purposes.10 However, the members may elect to tax the LLC as a corporation under the "Check-the-Box" Treasury Regulations."

C. Corporations

1. C Corporations

Most corporations are C corporations. Unless the taxpayer makes an affirmative election to be treated as a special type of corporation, it will be treated for federal income tax purposes as a C corporation.12 The C corporation is subject to tax separately from its owners for federal income tax purposes at rates up to 35%.13 In addition, the after-tax profits of the corporation are again subject to federal income tax when distributed to the shareholders.14

2. S Corporations

A corporation may elect to be taxed as a small business corporation under Subchapter S of the Internal Revenue Code (as amended, the "Code") if it meets the specific requirements listed in the Code.15

a. Requirements to Elect S Corporation Status

To qualify as an S Corporation, a corporation must have:

(1) A maximum of 100 shareholders;
(2) Only one class of stock; and
(3) No ineligible shareholders (i.e., only individual U.S. citizens or residents, estates and certain types of trusts).16

b. Taxation of S Corporations

An S corporation is generally not taxed at the entity level for federal income tax purposes.17 Instead,

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1 The authors would like to acknowledge the following individuals for their contributions in preparing this article: Tom Tippetts, Mark Robinson, Jr., Adam Hoffman, Muzzamil Hasan, Sammer Saxena and Marilyn Doolittle.
2 The authors note that certain information throughout Sections II through IV was derived in part from the following work: Richard M. Fijolek, Vicki L. Martin-Odette, Christina Markell-Balleza, Kim Szarynski and James Williamson, Choice of Business Structure (2010).
3 I.R.C. § 701.
4 I.R.C. § 701.
5 I.R.C. §§ 702-1(a).
6 I.R.C. §§ 1, 11(b).
7 See I.R.C. § 701; Treas. Reg. § 301.7701-3(a)-(b).
8 Treas. Reg. § 301.7701-3(b)(1)(ii).
9 Id. § 301.7701-3(a); see Section II (A)(1) below.
10 Id. § 301.7701-3(b)(1)(i).
11 Id. § 301.7701-3(a); see Section II (A)(1) below.
12 See I.R.C. § 1361(a)(2).
13 See id. §§ 11(a)-(b).
14 I.R.C. § 61(a)(7).
15 Id. § 1362.
16 See id. § 1361(b) (defining a "small business corporation").
all gains and losses flow through the corporation and are taxed at the shareholder level regardless of whether the income is actually distributed to the shareholders. There are a few important exceptions. The maximum rate of taxation for the shareholders is 35% (and 15% for capital gains on property held for more than one year).

III. THRESHOLD CONSIDERATIONS
A. Federal Tax Considerations (Other Than Benefits Considerations)

Generally, owners choose between (i) the simplicity and possibility of deferral of personal taxation offered by the corporate form or (ii) the flow-through of tax consequences for U.S. income tax purposes (generally by using an entity taxed as a partnership for U.S. income tax purposes or by using a single owner LLC that may be disregarded for federal income tax purposes).

1. Tax Classification of Entity
   a. "Check-the-Box Election"

   The Internal Revenue Service ("IRS") Treasury Regulations that implement an election or a "Check-the-Box" entity classification scheme have taken the confusion, complication and uncertainty out of the previous system for classifying entities. Under these Treasury Regulations, U.S. corporations and certain identified foreign entities will be treated as corporations for federal income tax purposes, but other entities (i.e., "eligible entities") are entitled to elect their tax classification.

   b. Default Rules

   Under default rules, newly formed eligible entities will be classified as follows unless an election otherwise is made:

   (1) A non-electing domestic eligible entity with two or more members is classified as a partnership (rather than as a corporation).
   (2) A non-electing domestic eligible entity with only one owner will be disregarded as an entity separate from its owner.

   (3) A non-electing foreign eligible entity is classified as a corporation if it has two or more members, all of which have limited liability.
   (4) A non-electing foreign eligible entity is classified as a partnership if it has two or more members and at least one member does not have limited liability.
   (5) A non-electing foreign eligible entity will be disregarded as a separate entity if it has a single owner without limited liability.
   (6) Generally, existing entities are not required to file elections to prevent reclassification under the default rules.

c. Election Mechanics

   Generally, an eligible entity will file an election with the IRS on Form 8832 and also provide a copy of the Form 8832 with its annual tax return. The election may be signed by either all the owners or an authorized officer, manager or owner. The election may have a retroactive effective date, not to exceed 75 days prior to the date of such election. If a retroactive effective date is chosen, all persons who have been owners at any time since the retroactive effective date must consent to and sign the election. An entity generally will be prohibited from changing its classification for 60 months after its initial election.

2. Significance of Tax Classification

   Classification of a business entity as a corporation or partnership (or as nonexistent) for federal income tax purposes has many tax consequences, including the following:

   a. Avoidance of Double Taxation

   An entity that is classified as a partnership or as a non-entity for U.S. tax purposes avoids a separate corporate level of taxation for the entity. The tax items of such pass-through entity flow through to, and are reported by, the owners thereof. This can be advantageous or disadvantageous. For example, while double taxation may be avoided, due to pass-through

17 See id. § 1363.
18 Id. § 1366; Treas. Reg. § 1.1366-1(a)(1).
19 See I.R.C. § 1(a), (b); Rev. Proc. 2009-50, 2009-45 IRB 617
20 See generally Treas. Reg. §§ 1.561-2 (considering dividends paid when received by the shareholder); 1.702-1(a) (requiring partners to include their share of partnership income even if not distributed).
21 See id. §§ 301.7701-1, 301.7701-2, 301.7701-3.
22 See id. §§ 301.7701-1, 301.7701-2, 301.7701-3.
23 Id. § 301.7701-3(b)(1)(i).
24 Id. § 301.7701-3(b)(1)(ii).
25 Id. § 301.7701-3(b)(2)(i)(A).
26 Id. § 301.7701-3(b)(2)(i)(B).
27 Id. § 301.7701-3(b)(2)(i)(C).
28 Id. § 301.7701-3(b)(3)(i).
29 Id. § 301.7701-3(e)(1)(i)(ii).
30 Id. § 301.7701-3(e)(2)(i).
31 Id. § 301.7701-3(e)(2)(ii).
32 Id. § 301.7701-3(e)(3)(i).
33 Id. § 301.7701-3(e)(3)(ii).
34 I.R.C. §§ 701; Treas. Reg. §§ 301.7701-2, 301.7701-3.
classification, there is no deferral of individual taxation.\(^6\)

b. Formation

Different rules apply upon the formation of a corporation or a partnership.\(^7\)

c. Special Allocations

Due to the single class of stock requirements, S corporations do not allow special allocations but partnerships do.\(^8\)

d. Use of Losses

Because many businesses produce initial losses, operating the business through a pass-through entity allows the losses to flow through to, and be reported by, the owners thereof.\(^9\) However, some loss limitations may apply.\(^40\)

e. Distributions or Dissolution

Because there may be significant tax costs to distributions or a dissolution or restructuring, the tax issues generally should be addressed from inception of the investment.

B. Benefit and Compensation Considerations

For several reasons, employee benefit and compensation considerations—particularly for owner-employees—can be significant issues in choosing a type of business entity.

1. Accident and Health Plans

The IRS generally takes the position that an individual cannot be both an employee and a partner with respect to the same entity. In other words, while an individual can be both an employee and a shareholder in a C corporation, a partner (or a member in an LLC) cannot also be an employee. Accordingly, partners and LLC members, as well as more than 2% shareholders in an S corporation (collectively, "self-employed individuals"), are treated differently than employees in the provision of many common types of benefits, even though they may provide the same services to a business entity as the entity’s other employees.\(^41\)

Perhaps most notably from a benefits perspective, employer-provided health and accident coverage, which is generally not included as income for employees, is includible in income for self-employed individuals. In addition, self-employed individuals cannot participate in the entity’s Section 125 cafeteria plan, health flexible spending arrangements, dependent care flexible spending arrangements, and health reimbursement arrangements.\(^43\)

On the other hand, self-employed individuals are allowed a corresponding deduction. Specifically, a self-employed individual can deduct as a business expense 100 percent of the amount paid during the tax year for medical insurance on himself, his spouse, and his dependents.\(^44\)

2. Other Fringe Benefits

Similarly, the following fringe benefits are excluded from employee compensation but not from the income of self-employed individuals:

a. meals or lodging furnished for the convenience of an employer;\(^45\)

b. qualified transportation fringes (e.g., qualified parking, transit passes);\(^46\) and

c. the provision of up to $50,000 of group-term life insurance.\(^47\)

By contrast, other fringe benefits are still excluded from income for self-employed persons, including working condition fringe benefits (e.g., use of a company car for business),\(^48\) educational assistance,\(^49\) and de minimis fringe benefits (e.g., holiday gifts and personal use of the copy machine).\(^50\)

3. Retirement Benefits

Historically, there were also significant differences between the treatments of self-employed individuals in tax-qualified retirement plans (e.g., profit sharing plans). Specifically, self-employed individuals were limited substantially as to the amount of annual deductible contributions to such plans. Most

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\(^36\) Compare Treas. Reg. § 1.702-1(a) (requiring partners to include their share of partnership income even if not distributed), with Treas. Reg. § 1.1561-2 (considering dividends paid when received by the shareholder).

\(^37\) Compare I.R.C. §§ 351, 358(a)(1), 362(a), with I.R.C. §§ 721-23.


\(^39\) I.R.C. § 702(a).

\(^40\) See, e.g., id. §§ 465, 469, 704(d).

\(^41\) Revenue Ruling 91-26.

\(^42\) I.R.C. §§ 105, 106.

\(^43\) I.R.C. §§ 125, 105(g); IRS Pub. 969.

\(^44\) I.R.C. § 162(l), No deduction is allowed to the extent that it exceeds the self-employed individual's earned income derived from the trade or business with respect to which the plan providing the medical care coverage is established.

\(^45\) I.R.C. § 162(l)(2).

\(^46\) I.R.C. § 119.

\(^47\) I.R.C. § 132.

\(^48\) I.R.C. § 79.

\(^49\) I.R.C. § 132(d).

\(^50\) I.R.C. § 132(e).
of the restrictions on self-employed individuals have been eliminated by statutory changes.\(^{51}\) Accordingly, the tax qualified retirement plan choices are ordinarily not a significant factor in the decision on choice of entity.

4. Compensation Arrangements

The compensation arrangement alternatives available for owners that are service providers differ between the entities.

a. C Corporations

Shareholders of C corporations are not subject to tax on dividends received from the C corporation under either the Self-Employment Contribution Act ("SECA"), which imposes a 15.3% employment tax on self-employment income, or the Federal Insurance Contribution Act ("FICA"), which imposes 15.3% employment tax on wages that is shared equally by employees and employers.\(^{52}\) For 2011, the FICA and SECA tax rate will be 13.3% due to a 2% reduction on the employer share of employment tax on wages under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.\(^{53}\)

b. S Corporations

Shareholders of an S corporation are not subject to SECA or FICA taxes on their distributive share of income from the S corporation.\(^{54}\) However, the S corporation and a shareholder that is also an employee will be required to pay FICA tax on any wages that the employee receives from the S corporation.\(^{55}\) Given this favorable treatment for distributions, some S corporations and their shareholders may attempt to minimize the amount of compensation that is payable to an S corporation shareholder. However, such wage classification may be subject to challenge if a service provider's compensation is unreasonably low and it is determined that the S corporation actually "pays" the service provider through dividends.\(^{56}\) This type of challenge is less likely if the S corporation retains income rather than distributing it to its shareholders.\(^{57}\)

c. Partnerships

Generally, a general partner's distributive share of income (as reduced by his distributive share of loss) will be subject to SECA tax and a limited partner's will not.\(^{58}\) However, a limited partner will be subject to SECA tax on any guaranteed payments received from the partnership in exchange for services (see more detailed discussion below).\(^{59}\)

d. Limited Liability Companies

There is currently no definitive guidance with respect to whether a member will owe SECA tax on his distributive share of income from an LLC. However, proposed Treasury Regulations provide some guidance indicating that if a member more closely resembles a general partner, his distributive share of income from an LLC will be subject to SECA tax, and if a member more closely resembles a limited partner, the opposite will be true.\(^{60}\)

e. Guaranteed Payments

If a partnership or an LLC taxed as a partnership for federal tax purposes provides a payment or benefit to a partner or member that reflects a relationship in which the partner or member is acting other than in the capacity of a partner or member (e.g., as an employee), the payment is for services rendered, and the amount of the payment is determined without regard to partnership or LLC income, it is considered a "guaranteed payment" and the partner or member will be treated as having received ordinary income that is subject to SECA.\(^{61}\) In other words, taxable fringe benefits, guaranteed bonuses, and the like will generally be taxable as ordinary income and subject to SECA.\(^{62}\)

5. Equity Compensation

The use and effect of equity compensation available also differs between entities. Today, the use of equity-based compensation—stock options, restricted stock, stock appreciation rights, etc.—is ubiquitous among corporate employers, particularly C corporations. Accordingly, many employees have come to expect to receive an equity stake in their employer as part of their compensation. Partnerships and LLCs can accommodate equity-based compensation, but the consequences of such arrangements can be significantly different than in the

\(^{51}\) Tax Equity and Fiscal Responsibility Act (TEFRA), P.L. 97-248.
\(^{52}\) See I.R.C. §§ 1401 (related to rate of SECA tax) and 3101 (related to rate of FICA tax).
\(^{54}\) Id. § 1402; Rev. Rul. 59-221, 1959-1 C.B. 225.
\(^{57}\) See eg. Ludeking v. Fich, 421 F.2d. 499 (8th Cir. 1970).
\(^{58}\) I.R.C. § 1402(a).
\(^{59}\) I.R.C. § 1402(a)(13).
\(^{60}\) Prop. Treat., Reg. § 1.1402(a)-2(h)(4).
\(^{61}\) IRC §§ 707(c) and 1402(a)(13).
\(^{62}\) Payments made to a partner (or a member of an LLC taxed as a partnership) other than in their capacity as a partner can also be subject to the nonqualified deferred compensation rules under Code Section 409A.
corporate context. Compensatory transfers of partnership interests are divided into two types: capital interests, which give the holder a share of the proceeds in a complete liquidation of the partnership; and profits interests, which entitle the holder to a percentage of post-grant partnership income and gain. Profits interests have become a popular tool for partnerships and LLCs, but the tax treatment of profits interests remains subject to some uncertainty.63,64

As noted above, the IRS generally takes the position that an individual cannot be both an employee and a partner with respect to the same entity. Accordingly, the consequences of awarding an ownership interest to an employee of a partnership or LLC are significant: that employee will likely be considered an owner, fundamentally altering the way that employee is taxed on the income he or she receives from the entity. For this reason, it is often desirable to compensate employees of a partnership or an LLC using equity-based arrangements (e.g., phantom equity plans) rather than true equity. However, such phantom equity arrangements are often foreign to employees and accordingly require additional communication. In addition, such arrangements are frequently subject to Code Section 409A, which may add complexity.

C. State Tax Considerations - Texas Franchise Tax

Texas franchise tax (or margin tax) is imposed on every limited partnership, LLP, corporation, LLC, business trust, professional association, business association, joint venture and other legal entities with statutory liability protection in Texas. Tex. Tax Code Section 171.001(a).65 The term "corporation" includes corporations that have elected S corporation status under the Code.66

The franchise tax rate is 0.5% for retail and wholesale entities (as defined in division F or G of the 1987 Standard Industrial Classification Manual published by the Federal Office of Management and Budget) and 1% for all other entities.67 This tax is imposed on the entity's margin.68 Margin equals the lesser of three calculations: (i) total revenue minus cost of goods sold; (ii) total revenue minus compensation paid; or (iii) total revenue multiplied by 70 percent.69 Total revenue is based on federal income tax reporting, with some exclusions.70 Taxpayers with total revenue that is less than the "no-tax-due" threshold amount and taxpayers with less than $1,000 otherwise due under the tax will not owe any franchise tax, but may still be required to file a "no-tax-due" report.71 For reports due on or after January 1, 2010 and before December 31, 2011, the "no-tax-due" threshold amount is $1,000,000.72 For reports due on or after January 1, 2012, the "no-tax-due" threshold amount is scheduled to decrease to $600,000.73 In all cases, the "non-tax-due" threshold amount may be adjusted up or down each even-numbered year based on the Consumer Price Index for All Urban Consumers.74

There are other exemptions available with respect to the Texas franchise tax, but a detailed discussion of those exemptions is beyond the scope of this article. However, one that is worth noting is the exemption for "passive entities." Under the Texas Tax Code, a "passive entity" is not a "taxable entity."75 Only GPs, LPs or trusts, other than a business trust can qualify for this exemption.76 An LLC cannot qualify for this exemption.77 To qualify for this exemption, at least 90% of an eligible entity's federal gross income must be "passive."78 "Passive income" is specifically defined in the Texas Tax Code, and includes dividends, interest, distributive shares of partnership income, capital gains from the sale of real property, gains from the sale of securities, royalties and income from other non-operating mineral interests.79 Notably, the definition of "passive income" specifically excludes rent.80 The determination of whether an entity will be classified as "passive" is made on an annual basis.

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63 Revenue Procedure 93-27 creates a safe harbor under which the grant of a profits interest is not a taxable event to the recipient. The revenue procedure does not apply: (1) if the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (2) if the profits interest holder disposes of the profits interest within two years of receipt; or (3) if the profits interest is in a publicly-traded partnership.

64 Under existing guidance, transfers of compensatory partnership interests generally should not be subject to Code Section 409A. However, future guidance could change this result.

65 Tex. Tax Code Ann. § 171.0002 (defining "taxable entity"). § 171.001 (imposing tax on taxable entities).

66 See 34 Tex. Admin. Code § 3.581(b)(3), (c).


69 Id. § 171.101(a).

70 Id. § 171.1011.

71 Id. §§ 171.0002(d). 171.204.

72 Id. § 171.002(d)(2) effective January 1, 2010.

73 Id. effective January 1, 2012.

74 Id. § 171.006.

75 Id. §§ 171.0002-.0003.

76 Id. § 171.0003(a)(1).

77 Id.

78 Id. § 171.0003(a)(2).

79 Id. § 171.0003(a)(2).

80 Id. § 171.0003(a)(3)(b)(1).

81 Id. § 171.0003(a)(2).
IV. THE BENEFITS OF USING A FLOW-THROUGH ENTITY: A PARTNERSHIP OR LLC VERSUS AN S CORPORATION.

A. In General

The three entities of choice for flow-through treatment are partnerships, LLCs taxed as partnerships and S corporations.\(^{82}\) (As used in this Section IV, LLC shall mean an LLC taxable as a partnership.) All three entities are generally not subject to federal income taxation.\(^{86}\) Instead, all gains and losses flow-through and are taxed at the owner level, thereby eliminating the double taxation of gains associated with entities taxable as corporations.\(^{88}\) The following is a general discussion and comparison of the use of a partnership or LLC versus an S corporation.

B. Formation Issues

1. Eligible Owners of the Entity

a. Partnerships / LLCs

Partnerships and LLCs generally have no restrictions on the number and types of eligible owners.\(^{85}\)

b. S Corporations

An S corporation can have up to 100 eligible shareholders.\(^{86}\) Eligible shareholders include only U.S. citizens and residents, estates and certain types of trusts.\(^{87}\) Thus, S corporations have far more restrictive ownership requirements than partnerships. For purposes of calculating the number of eligible shareholders, a married couple and families (consisting of a common ancestor, lineal descendants of that common ancestor up to six generations, and their spouses) are considered a single shareholder.\(^{88}\)

2. Tax Basis of Interest in the Entity

a. Partnerships / LLCs

When an owner contributes property to a partnership or LLC, the owner is given tax basis in his partnership or LLC interest equal to the tax basis of the property contributed.\(^{89}\) In addition, an owner's tax basis in the entity includes his share of the entity's liabilities.\(^{90}\)

b. S Corporations

When a shareholder contributes property to an S corporation, the shareholder is given tax basis in his stock equal to the tax basis of the property contributed, as well as amounts he loaned to the corporation.\(^{91}\) However, unlike partnerships, a shareholder cannot include corporate level liabilities in the tax basis of his stock.\(^{92}\)

3. Contributions of Property to the Entity

In general, a contribution of property to a partnership, LLC or S corporation in exchange for an equity interest in that entity is not a taxable event.\(^{93}\) However, for a contribution of property to an S corporation (or any entity taxable as a corporation) to be tax-free, the transferor shareholders must "control" (i.e., own 80% of all class of stock entitled to vote and at least 80% of all other classes of stock) the corporation immediately after the transfer.\(^{94}\) However, a contribution of encumbered property to an entity can trigger gain in certain circumstances, as discussed below.

a. Partnerships / LLCs

If a partnership or LLC assumes the debt on property contributed to the entity, the contributing owner is deemed relieved of the liability, and thus deemed to receive a cash distribution from the entity, which reduces his tax basis in his entity interest.\(^{95}\) However, the owner is deemed to assume his share of the entity's debt, which is treated as a cash contribution to the entity and thus increases his tax basis in the entity interest.\(^{96}\) Thus, if an owner is deemed to have a net cash distribution in excess of his tax basis in the entity, the owner will recognize gain equal to the amount of the excess.\(^{97}\)

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\(^{82}\) See supra Section II.
\(^{83}\) I.R.C. §§ 701, 1363.
\(^{84}\) Id. §§701-702, 1366.
\(^{85}\) See, e.g., Del. Code Ann. tit. 6, §§ 15-101(1) (defining a partner as a person admitted to a partnership), 15-202 (requiring 2 or more partners to form a partnership), 18-301 (providing the requirements for a person to be admitted to a limited liability company); Tex. Bus. Orgs. Code Ann. §§ 101.101 (allowing 1 or more members to form a limited liability company), 101.102 (providing that any person with capacity may be a member), 152.051 (requiring 2 or more partners to form a partnership), 152.053 (allowing any person with capacity to be a partner).
\(^{86}\) I.R.C. § 1361(b)(1)(A).
\(^{87}\) Id. § 1361(b)(1)(B)-(C).
\(^{88}\) Id. § 1361(c)(1).
\(^{89}\) Id. § 722.
\(^{90}\) Id. § 752.
\(^{91}\) Id. §§ 358(a), 1367; Treas. Reg. § 1.1367-1(a)(2).
\(^{92}\) Compare I.R.C. § 752 and related Treas. Regs. (describing the effect that liabilities have on a partner’s basis in his partnership or LLC interest) with I.R.C. § 1367(a) (describing the basis adjustments allowed for S corporation shareholders).
\(^{93}\) Id. §§ 351(a), 721(a).
\(^{94}\) Id. §§ 351(a), 368(a).
\(^{95}\) I.R.C. §§ 733, 752(b); Treas. Reg. § 1.752-1(f).
\(^{96}\) I.R.C. §§ 722, 752(a); Treas. Reg. § 1.752-1(f).
\(^{97}\) Id. § 731(a)(1); Treas. Reg. g.1.752-1(f).


b. S Corporations

In general, a contribution of encumbered property to an S corporation will be tax-free under Code Section 351. However, when the liabilities encumbering the property exceed the contributor’s tax basis in the contributed property, the contributing shareholder will recognize gain under Code Section 357.

4. Interest Received for Services

Service providers often receive, in exchange for their services, an interest in the entity for which they provide services. The tax consequences of receiving such an interest for services are governed by Code Section 83. In general, the service provider will be immediately taxed on the receipt of the interest in the entity unless the interest is burdened with restrictions and subject to risks of forfeiture.

a. Partnerships / LLCs

If properly structured, an interest in a partnership or LLC can be given to a service provider without immediate taxation. The entity can issue a profits interest to the service provider, and he will be taxed only when he is allocated income from the entity or receives distributions from the entity.

b. S Corporations

A service provider cannot receive stock in an S corporation in exchange for services without immediate taxation unless such stock is burdened with restrictions and subject to risks of forfeiture. When the restrictions lapse and the stock is no longer subject to forfeiture, the shareholder will be taxed on the fair market value of the interest (unless he made a Code Section 83(b) election to be taxed on the stock at the time of grant). An S corporation cannot issue a profits interest (or similar instrument) because the S corporation rules do not allow for special allocations of taxable items, profits or losses because the S corporation can issue only one class of stock and each share of stock must be treated the same economically. Thus, partnerships and LLCs provide taxpayers with a great deal of flexibility.

C. Operational Issues of the Entity

1. Special Allocations of Income or Loss

Partnerships, LLCs and S corporations are pass-through entities so each owner must include his distributive share of the profits and losses of the entity on his tax return.

a. Partnerships / LLCs

A partnership or LLC agreement can provide for special allocations that give an owner a distributive share of a particular taxable item or classes of taxable items that is different from the proportion in which the owner shares in other profits and losses of the entity. For example, certain owners can receive preferred returns and/or a return of capital before other owners share in the profits of the entity. Thus, partnerships and LLCs provide taxpayers with a great deal of flexibility.

b. S Corporations

Unlike a partnership or LLC, the S corporation rules do not allow for special allocations of taxable items, profits or losses because the S corporation can issue only one class of stock and each share of stock must be treated the same economically. Instead, profits and losses are allocated to the shareholders pro rata based on stock ownership.

2. Allocations of Pre-Contribution Gain or Loss

a. Partnerships/LLCs

When an owner contributes property to a partnership or LLC, any gain or loss inherent in the property on the date of contribution ("built-in-gain or loss") must be recognized by the contributing partner typically upon a future sale or disposition of the property. Any gain or loss in excess of the built-in-gain or loss amount is allocated among the partners as provided in the entity’s agreement.

b. S Corporations

The S corporation rules do not require that built-in-gain or loss on contributed property be recognized by the contributing partner upon a future sale or disposition of the property. Instead, each shareholder will recognize his pro rata share of any gains or losses from future sales of such contributed property.

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98 I.R.C. § 351(a); Treas. Reg. § 1.1367-1(a)(2).
99 I.R.C. § 357(c); Treas. Reg. § 1.1367-1(a)(2).
100 See I.R.C. § 83.
101 Id. § 83(a).
104 I.R.C. §§ 83(a), 83(c)(1).
105 Id. §§ 83(a), 83(b).
106 I.R.C. § 1361(b)(1)(D); Treas. Reg. § 1.1361-1(0)(1).
107 I.R.C. §§ 702, 1366.
108 Id. § 704(a).
110 I.R.C. § 1366(a)(1).
111 I.R.C. § 704(c); Treas. Reg. § 1.704-3.
112 See generally I.R.C. § 704(a). (c)(1).
113 See id. § 1366(a)(1).
114 Id. § 1366(a)(1).
3. General Distribution Rules
   a. Partnerships/LLCs
      A partnership or LLC recognizes no gain on a distribution of cash or other property to its owners.\textsuperscript{115} An owner recognizes gain only when he receives cash in excess of his basis in his entity’s interest, and property distributions by an entity to an owner will generally not give rise to gain at the entity or owner level.\textsuperscript{116}

   b. S Corporations
      Generally, an S corporation is not required to pay any tax on the distribution of cash or other property to its shareholders.\textsuperscript{117} For most S corporation shareholders, distributions are tax free up to the amount of a shareholder’s stock basis, and any excess over stock basis will be treated like gain from the sale of property.\textsuperscript{118} The treatment of a distribution at the shareholder level may be different if the S corporation has accumulated earnings and profits.\textsuperscript{119} However, most S corporations that were formed after 1982 and that were never a C corporation should not have any accumulated earnings and profits.\textsuperscript{120}

4. Distributions of Property to Owners
   a. Partnerships/LLCs
      A contribution of property to a partnership followed by a distribution to an owner may be characterized as a sale or exchange of property between the owner and the entity.\textsuperscript{121} There is a presumption that lasts for two years that if there is a direct or indirect transfer of money or other property by the entity to such owner (or other partners), the transaction may be characterized as a sale.\textsuperscript{122}

      In addition, if an owner contributes property with a built-in-gain, that gain must be recognized by the contributing owner if the contributed property is distributed to another owner within 7 years of the date of the contribution.\textsuperscript{123} In addition, if the contributing owner receives a distribution of other property from the entity within 7 years of the date of the contribution, such owner must recognize all or a portion of the built-in-gain.\textsuperscript{124}

   b. S Corporations
      When an S corporation distributes property to a shareholder, the S corporation is treated as if it sold the property and distributed cash to the shareholder.\textsuperscript{125} The gain recognized is allocated pro rata among the shareholders based on stock ownership.\textsuperscript{126} Unlike partnerships, the S corporation rules do not allow for the allocation of built-in-gains or losses back to the contributing shareholder.\textsuperscript{127}

5. Sale of Interests
   a. Partnerships/LLCs
      An owner who disposes of his equity interest in a partnership or LLC generally recognizes capital gain or loss.\textsuperscript{128} However, if the entity holds inventory or receivables, some of the gain may be recharacterized as ordinary income.\textsuperscript{129}

      If more than fifty percent (50%) of the total interest in the entity’s capital and profits is sold or exchanged within a twelve (12) month period, the partnership or LLC will terminate for federal income tax purposes, which can cause considerable complications as well as adverse tax consequences for the entity and its owners.\textsuperscript{130} Each time there is an ownership change, an interim closing of the entity’s books must be made to determine each owner’s distributive share of income, gain, loss, deduction or credit, unless the owners agree to allocate each entity item on a pro rata basis for the year.\textsuperscript{131}

   b. S Corporations
      A shareholder who disposes of his stock in the S corporation generally recognizes capital gain or loss.\textsuperscript{132} However, a shareholder who sells his stock at a loss may be allowed to take up to a $50,000 loss ($100,000 if married filing jointly) in any taxable year as an ordinary loss instead of a capital loss under Code Section 1244.\textsuperscript{133}

      When a shareholder sells its stock in an S corporation, each owner’s distributive share of income, gain, loss, deduction or credit, is determined on a per-day pro rata basis based on stock ownership.\textsuperscript{134}
V. OWNER LIABILITY

A principal factor to consider when choosing a type of entity is the ability to limit the liability of the owner, or certain owners, of the business.

A. Corporations

1. Limited Liability: Protection from Personal Liability for Actions of the Corporation

One of the fundamental reasons to do business as a corporation is limited liability for the shareholders of the corporation. While shareholders are free to guarantee corporate obligations, thereby subjecting themselves to personal liability, as a general rule, directors, officers and shareholders are not personally liable for the actions of a corporation. This limitation of personal liability stems from the theory that the corporation is an entity that is separate from its individual shareholders. There are, however, some circumstances where courts will disregard this general protection from personal liability and subject directors, officers and shareholders to liability for corporate obligations.

2. Piercing the Corporate Veil

Typically, shareholders of a corporation will not be personally liable for obligations of the corporation beyond their respective investments in the corporation. On rare occasions, however, a court will "pierce the corporate veil" or "disregard the corporate entity" and hold a shareholder personally liable for the actions of the corporation.

A shareholder of a Texas corporation generally will not be liable for contractual obligations of the corporation on the basis that the holder is or was the alter ego of the corporation or on the basis of fraud or a similar theory, unless it is demonstrated that the shareholder caused the corporation to be used for the purpose of perpetrating an actual fraud, primarily for the direct personal benefit of the shareholder or an affiliate of the shareholder. Further, a shareholder in Texas may not be held liable for any obligation on the basis that the corporation failed to observe any corporate formality.

In addition, the Texas Supreme Court has stated that corporations cannot be held liable for each other’s obligations, whether arising in tort or contract, merely because they are part of a single business enterprise. Veil-piercing theories in Texas are applicable only to shareholders and have never been used by a Texas court to hold an officer liable for the obligations of the entity.

B. General Partnerships

The most unfavorable element of doing business as a general partnership is the unlimited liability exposure of the partners.

1. General Partnership Liable for the Acts of Its Partners

In Texas, a general partnership is liable for loss or injury to a person, including a partner, or for a penalty caused by or incurred as a result of a wrongful act or omission of a partner acting in the ordinary course of the partnership's business or with the authority of the partnership.

2. Joint and Several Liability of Partners

All partners in a general partnership are jointly and severally liable for the debts and obligations of the partnership unless otherwise agreed to by a claimant or otherwise provided by law, except for newly-admitted partners with respect to pre-admission actions or omissions or with respect to contractual obligations entered into before the partner's admission, and where a partnership is organized as an LLP. Generally, attempts to allocate liability among the partners in a general partnership through the partnership agreement are not effective against third-party creditors. A creditor of a Texas partnership, however, typically must first exhaust the assets of the partnership before proceeding against the individual partners.

3. Partners Right of Contribution

Where a partner reasonably makes a payment in connection with a partnership liability or obligation beyond the amount allocable to that partner's share of such liability or obligation, that partner may have a right of contribution from the partnership or the partners of the partnership who did not pay in accordance with their allocable share of such liability or obligation.

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137 TBOC § 21.223.
138 TBOC § 21.223(a)(3).
141 TBOC §§ 152.801
142 TBOC § 152.303(a).
143 TBOC §§ 152.304(a), 152.801
144 Egan, at 68
145 TBOC § 152.306.
4. **Newly Admitted Partners Not Liable for Pre-Admission Acts of General Partnership**

A person admitted as a partner into an existing general partnership in Texas does not have personal liability for an obligation of the partnership that arose prior to the partner’s admission, relates to an action occurring before the partner’s admission, or arises under a contractual obligation or commitment entered into prior to the partner’s admission.¹⁴⁶

5. **Liability for Wrongful Withdrawal**

A partner’s withdrawal from the general partnership is wrongful only if it breaches an express provision of the partnership agreement, the partner is expelled by judicial decree, or in certain circumstances, the partner withdraws prior to a stated duration or specified undertaking of the partnership.¹⁴⁷ In such situations, the withdrawing partner is liable to both the other partners and the partnership for any damages caused by the withdrawal.¹⁴⁸ Further, a partner’s withdrawal does not discharge the partner’s liability for an obligation of the partnership incurred prior to the date of withdrawal.¹⁴⁹

C. **Limited Partnerships**

1. **Unlimited Liability for General Partner**

The general partner of a Texas limited partnership has unlimited liability just as a partner in a general partnership.¹⁵₀

2. **Limited Liability of Limited Partners**

A limited partner’s liability, however, for claims against the limited partnership is similar to that of a shareholder of a corporation in that it is limited to the partner’s capital contribution to the partnership, unless the limited partner otherwise participates in control of the partnership’s business.¹⁵¹ If a limited partner participates in the control of the business of the limited partnership, the protection of limited liability may not be available to that partner.¹⁵² Section 153.103 of the Texas Business Organizations Code ("TBOC") provides a rather extensive list of actions that do not constitute participation in the business of the limited partnership.¹⁵³ To the extent a limited partner’s activities exceed those allowable under the safe harbor of Section 153.103, the limited partner will be liable only to a person who transacts business with the limited partnership reasonably believing, based on such limited partner’s conduct, that the limited partner is a general partner.¹⁵⁴ Texas limited partnerships are not subject to piercing of the corporate veil.¹⁵⁵

D. **Limited Liability Companies**

Except as and to the extent specifically provided by the limited liability company agreement ("LLC Agreement"), neither members nor managers of an LLC are liable for the debts, obligations or liabilities of an LLC organized under the laws of the State of Texas.¹⁵⁶ Unlike limited partners in a limited partnership, members may participate in the management of the LLC without forfeiting the protections of limited liability. Further, although not settled in Texas, the concept of piercing the corporate veil appears not to apply to LLCs.¹⁵⁷

E. **Limited Liability Partnerships**

1. **Joint and Several Liability Changed by LLP Status**

An LLP is a general partnership, but the unlimited joint and several liability associated with a general partnership changes when the general partnership attains LLP status. Unless caused by a particular partner, LLP status works to shield the partner from individual liability for the partnership’s debts and obligations.

With certain exceptions, or as provided by the partnership agreement, a partner in an LLP is not personally liable to any person, including another partner, directly or indirectly, for a debt or obligation of the partnership incurred while the partnership is an LLP.¹⁵⁸

2. **Exceptions for Supervision, Direct Involvement or Knowledge**

A partner in an LLP may be personally liable for an obligation of the partnership arising from an act committed by another partner or representative of the partnership if the partner, at the time of the occurrence:

a. was supervising or directing the other partner or representative;

b. was directly involved in the specific activity; or

¹⁴⁶ TBOC § 152.304(b).
¹⁴⁷ TBOC § 152.503(b).
¹⁴⁸ TBOC § 152.503(c).
¹⁴⁹ TBOC § 152.505(a).
¹⁵₀ TBOC § 153.152.
¹⁵¹ TBOC § 153.102.
¹⁵² Id.
¹⁵³ TBOC § 153.103.
¹⁵⁴ TBOC § 153.102(b).
¹⁵⁵ Asshauer v. Wells Fargo Foothill, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008); Egan, at 78.
¹⁵⁶ TBOC § 101.114
¹⁵⁷ Egan, at 115.
¹⁵⁸ TBOC § 152.801(a).
c. had notice or knowledge of the act by the other partner or representative and failed to take reasonable action.\textsuperscript{159}

VI. MANAGEMENT

Control and management of Texas business entities varies significantly depending on the type of entity involved.

A. Corporations

1. Centralized Management

One of the tenets of the corporate form is centralized management. The shareholders of the corporation elect the directors.\textsuperscript{160} The board of directors exercise or authorize the exercise of the powers of the corporation and manage the affairs of the corporation.\textsuperscript{161} The corporation, however, must obtain shareholder approval with respect to certain fundamental matters.\textsuperscript{162}

2. Election of Officers

The board of directors elects a president and secretary of the corporation, and other officers as necessary, to manage the day-to-day business needs of the corporation.\textsuperscript{163} Officers and directors of a corporation may be shareholders of the corporation, but shareholders, in their capacity as shareholders, have no authority to directly manage the corporation's business and affairs, unless provided otherwise in a shareholders agreement.

3. Shareholders Agreements May Limit Board Power

The shareholders of a Texas corporation may enter into an agreement that places certain restrictions on its board of directors or eliminates the board of directors altogether and authorizes one or more of its shareholders to manage its business and affairs.\textsuperscript{164} A shareholders agreement that purports to limit the power of a corporation's board of directors must be:

a. contained in the certificate of formation or bylaws if approved by all of the shareholders at the time of the agreement, or
b. a written agreement signed by all shareholders and made known to the corporation.\textsuperscript{165}

B. General Partnerships

Partners in a general partnership have considerable freedom to structure management in the partnership agreement.\textsuperscript{166} Except to the extent that the partnership agreement provides otherwise, each partner has equal rights in the management and conduct of the business of the general partnership.\textsuperscript{167} Each partner is an agent of the partnership and generally binds the partnership and the other partners, unless the partner has no authority and that fact is known to the counterparty. In such a situation, management of the partnership is decentralized. Partners in a general partnership, however, will often centralize management by designating a managing partner to manage the business of the partnership.\textsuperscript{168}

C. Limited Partnerships

Management of a limited partnership typically is centralized in the general partner, since the general partner retains the rights and powers of a partner in a general partnership.\textsuperscript{169} The partnership agreement, however, may establish classes or groups of partners having certain express rights, powers or duties, including voting rights.\textsuperscript{170}

D. Limited Liability Companies

1. Managed by Members or Managers

The governing authority of an LLC consists of its managers (if the certificate of formation states that the company will have managers), which can be entities or individuals, or its members (if the certificate of formation states there will not be managers).\textsuperscript{171} The governing authority will manage the business and affairs of the company in accordance with the LLC Agreement and the TBOC.\textsuperscript{172} In many instances, LLCs are organized to be manager-managed for day-to-day business operations, but require member approval for major decisions or transactions. Managers of an LLC need not also be members.\textsuperscript{173}

2. Functions Similar to a Board of Directors; May Appoint Officers

The governing authority may function similar to a board of directors of a corporation and may choose to appoint officers and other agents to act on behalf of the LLC to manage day-to-day business needs of the company.\textsuperscript{174}

\textsuperscript{159} TBOC § 152.801(b).
\textsuperscript{160} TBOC § 21.405
\textsuperscript{161} TBOC §21.401
\textsuperscript{163} TBOC §21.417
\textsuperscript{164} TBOC § 21.101(a).
\textsuperscript{165} TBOC § 21.101(b).
\textsuperscript{166} Egan, at 69.
\textsuperscript{167} TBOC § 152.203(a).
\textsuperscript{168} Egan, at 69-70.
\textsuperscript{169} TBOC § 153.152
\textsuperscript{170} TBOC § 154.101
\textsuperscript{171} TBOC § 101.251
\textsuperscript{172} TBOC § 101.252
\textsuperscript{173} TBOC §§ 101.251-101.253; Egan, at 103.
VI. FIDUCIARY DUTIES

The duties for which the owners or managers of a business entity shall be responsible are generally of primary concern in deciding on a type of entity.

A. Corporations

1. Duties of Care, Loyalty and Obedience

In Texas, the directors of a corporation owe certain fiduciary duties to the corporation and its shareholders, including the duties of loyalty, care, and obedience. The duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation. The duty of loyalty typically means that a director must act first and foremost in the best interest of the corporation and must not seek personal gain or advantage at the corporation’s expense. The duty of care has been defined in Texas as requiring directors to handle their corporate duties with such care as an ordinarily prudent person would under similar circumstances. The duty of obedience requires a director to avoid committing acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation.

2. Business Judgment Rule

The business judgment rule generally operates to protect a director of a corporation from liability so long as the director’s decision was made on “an informed basis, in good faith, and in the honest belief that the action taken was in the best interests” of the corporation. Under Texas law, the business judgment rule states that Texas courts will not impose liability upon a disinterested corporate director unless the challenged action is ultra vires or is tainted by fraud.

B. General Partnerships

1. Duties of Care and Loyalty

In Texas, a partner owes to the partnership and the other partners, and a transferee of a deceased partner’s interest, the duties of care and loyalty. A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.

A partner’s duty of loyalty includes the following:

a. accounting to, and holding for the partnership property, any profit or benefit derived by the partner in the conduct and winding up of the partnership’s business or from the use by the partner of partnership property;
b. refraining from dealing with the partnership on behalf of someone with an interest adverse to that of the partnership; and
c. refraining from competing or dealing with the partnership in an adverse manner.

2. Liability to the Partnership and Other Partners

A partner is liable to a partnership and the other partners for a breach of the partnership agreement or a violation of a duty to the partnership or other partners that causes harm to the partnership or the other partners. Texas courts have stated that managing
partners owe their co-partners the highest fiduciary
duty recognized in law.\textsuperscript{188}

C. Limited Partnerships

1. General Partners Have Same Fiduciary Duties as
Partners in a General Partnership

General partners of limited partnerships are held
to the same fiduciary standards as those of partners in
general partnerships (i.e., a duty of loyalty and a duty of
care).\textsuperscript{189}

Unless the partnership agreement states
otherwise, general partners in limited partnerships
have the same rights, powers, duties and liabilities as
partners in general partnerships. Thus, general
partners in limited partnerships owe the same duties of
care and loyalty to the partnership and the other
partners.\textsuperscript{190}

In Texas, a partner does not violate a duty or
obligation to the partnership or the other partners
merely because the partner's conduct furthers the
partner's own interest.\textsuperscript{191} Furthermore, a partner, in
the capacity as partner, is not a trustee and is not held
to the standards of a trustee.\textsuperscript{192}

2. General Partners Owe Higher Fiduciary
Standards to Limited Partners

Due to the extent of the general partner's control
over the partnership, Texas courts have indicated that
general partners are subject to a higher fiduciary
standard with respect to the other partners in the
limited partnership.\textsuperscript{193}

3. Limited Partners Generally Do Not Owe
Fiduciary Duties To the Other Partners or the
Partnership

Limited partners do not have the same
obligations, nor owe the same duties, as a general
partner to the other partners solely by reason of their
being a limited partner.\textsuperscript{194}

4. Partnership May Set Parameters for Fiduciary
Duties

Section 152.002(b) of the TBOC states that a
partnership may set parameters for, but not eliminate,
the obligation of good faith and the duties of care and
loyalty in its partnership agreement.\textsuperscript{195} The statute
provides flexibility to the partnership in setting these
parameters, as long as the parameters set by the
partnership are not manifestly unreasonable.\textsuperscript{196}

D. Limited Liability Companies

1. LLC May Modify Fiduciary Duties

Although the TBOC does not explicitly address
the fiduciary duties associated with the members or
managers of an LLC, Section 101.401 specifically
states that "the company agreement of a limited
liability company may expand or restrict any duties,
including fiduciary duties" that a member or manager
has to the company or to other members and
managers.\textsuperscript{197} Depending on the management structure
of the LLC, the fiduciary duties of the members or
managers to the LLC and to the other members and
managers should be similar to the duties that corporate
directors owe to the corporation and the shareholders
of the corporation.\textsuperscript{198}

2. Interested Member/Manager Transactions

The TBOC states that an otherwise valid contract
or transaction between an LLC and any of its
governing persons or officers, or between an LLC and
another entity where any of its governing persons or
officers have a managerial or financial interest is valid
notwithstanding the fact that the governing person or
officer is present at or participates in the meeting
where such contract or transaction is authorized if one
of the following conditions is met:

a. the material facts as to the relationship or
interest involved in the contract or
transaction are disclosed to or known by (i)
the LLC's governing authority, and the
governing authority in good faith authorizes
the contract or transaction by the approval of
a majority of the disinterested governing
persons, even where the disinterested
persons are less than a quorum or
(ii) the members, and the transaction is
approved in good faith by a vote of the
members; or

b. the contract or transaction is fair to the LLC
at the time of authorization, approval or
ratification by the governing authority or
members.\textsuperscript{199}

E. Limited Liability Partnerships

Although not specifically addressed by the
TBOC, Texas courts have indicated that the partners

\textsuperscript{188} Hughes v. St. David's Support Corp., 944 S.W.2d 423,
\textsuperscript{189} Id.
\textsuperscript{190} Egan, at 79-80; TBOC §§ 153.003, 153.152, 152.204(a).
\textsuperscript{191} TBOC § 152.204(c).
\textsuperscript{192} TBOC § 152.204(d).
\textsuperscript{193} See Palmer v. Faqua, 641 F.2d 1146, 1155 (5th Cir.
\textsuperscript{194} TBOC § 153.003(c)
\textsuperscript{195} TBOC § 152.002(b).
\textsuperscript{196} TBOC § 101.401
\textsuperscript{197} Egan, at 104.
\textsuperscript{198} TBOC § 101.255(a)-(b)
in an LLP are in a fiduciary relationship and owe each other fiduciary duties.  

VIII. FORMALITIES OF ORGANIZATION

Another important consideration in selecting a form of entity is the ease and costs associated with organizing the entity.

A. Corporations

1. Filing of Certificate of Formation

The formation of a Texas corporation requires a certificate of formation to be filed with the Secretary of State along with payment of a $300 filing fee. The certificate of formation establishes the initial board of directors, the capital structure of the corporation and designates a registered agent and office for service of process in Texas. After the Secretary of State officially acknowledges the filing of the corporation's certificate of formation, an organizational meeting of the initial board of directors is generally held for the purposes of adopting bylaws, electing officers and transacting such other business as may come before the meeting. In lieu of an organizational meeting, a corporation's initial directors may sign an organizational consent accomplishing the same tasks.

2. Creation of Bylaws

The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the corporation's certificate of formation. Shareholders may amend, repeal or adopt changes to bylaws, unless the certificate of formation or bylaws adopted by the shareholders provide otherwise.

3. Appointment of Registered Agent

Under the TBOC, the appointed registered agent of any newly-formed corporation must have consented to service in such capacity and failure to obtain and maintain such consent may subject a corporation to potential civil and/or criminal liability.

B. General Partnerships

1. No Formalities for Creation

There are no formalities in the creation of a general partnership. A general partnership does not require a written partnership agreement or any formal filing to be submitted to the Secretary of State, and may be formed solely by the existence of an association of two or more persons carrying on, as co-owners, a business for profit.

2. Partnership Agreement Generally Preferable to Statutory Governance

Although not required, partners often prefer to enter into a partnership agreement rather than rely solely on the default statutory provisions of the TBOC to govern their partnership. If a partnership agreement has been entered into, the provisions of that agreement will govern the partnership; however, where the partnership agreement is silent concerning a particular issue, the provisions of the TBOC will govern instead. In addition, a partnership agreement may not do the following:

- unreasonably restrict a partner's statutory rights of access to books and records;
- eliminate the duty of loyalty, although the agreement may within reason identify specific types of activities that do not violate the duty of loyalty;
- eliminate the duty of care;
- eliminate the obligation of good faith;
- vary the power to withdraw as a partner, except to require the notice be in writing; or
- vary certain other requirements.

However, the scope of the duties of good faith, care and loyalty may, within reason, be contractually limited by the terms of a partnership agreement.

C. Limited Partnerships

1. Formation More Costly Than Other Entities

The cost of forming a limited partnership is usually greater than that of forming a general partnership. A certificate of formation must be filed with the Secretary of State containing the following:

- the name of the entity;
- a statement that it is a limited partnership;
- the name and address of each general partner;
- the address of the registered office and the name and address of the registered agent for service of process; and
- the address of the principal office where books and records are to be kept.

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200 Egan, at 146.
201 TBOC § 3.005(a)(5).
202 TBOC § 21.059.
203 TBOC § 21.057.
204 TBOC § 21.058.
205 TBOC § 5.201(b), as amended in the 2009 Legislative Session by H.B. 1787 effective January 1, 2010.
206 TBOC § 5.207, TBOC §§ 4.007 and 4.008.
207 TBOC § 152.051.
208 See Pappas v. Gounaris, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).
209 TBOC § 152.002(a).
210 TBOC § 152.002(b).
211 TBOC § 152.002.
212 TBOC §§ 3.001, 3.005, 3.011.
Additionally, a filing fee of $750 must be paid upon filing the certificate of formation.\textsuperscript{215}

2. Limited Partnership Agreements

Except as provided in the TBOC, partners generally have the freedom to contract around the default provisions provided under Texas law.\textsuperscript{214} The TBOC assumes the existence of a limited partnership agreement ("LPA"),\textsuperscript{215} and allows the agreement to be either written or oral\textsuperscript{215} (although an oral LPA may be subject to the statute of frauds).\textsuperscript{216} Furthermore, the name of the limited partnership must contain the word "limited," the phrase "limited partnership" or an abbreviation of either.\textsuperscript{217} Unless the LPA provides otherwise, unanimity is required to amend an LPA.\textsuperscript{218}

D. Limited Liability Companies

1. Filing of Certificate of Formation

An LLC may be formed upon the filing of a certificate of formation with the Texas Secretary of State along with a $300 filing fee,\textsuperscript{219} (unless the certificate of formation provides for delayed effectiveness).\textsuperscript{220} The initial certificate of formation must contain the following:

\begin{itemize}
  \item a. the name of the LLC;
  \item b. a statement that it is an LLC;
  \item c. the period of its duration, unless such duration is perpetual;
  \item d. its purpose, which may be any lawful purpose for which LLCs may be organized;
  \item e. the address of its initial registered office and the name of its initial registered agent at that address;
  \item f. if the LLC is to have a manager or managers, a statement to that effect and the names and addresses of the initial manager or managers, or if the LLC will not have managers, a statement to that effect and the names and addresses of the initial members;
  \item g. the name and address of each organizer; and
  \item h. specified information if the LLC is to be a professional LLC.
\end{itemize}

In addition, the initial certificate of formation may contain any other provisions not inconsistent with law.\textsuperscript{221} The name of an LLC must contain words or an abbreviation to designate the nature of the entity, such as "limited liability company," "limited company" or "LLC."\textsuperscript{222} The chosen name may not be the same as or deceptively similar to that of any domestic or foreign filing entity authorized to transact business in Texas.\textsuperscript{223}

E. Limited Liability Partnerships

1. Filing of LLP Application

Under the TBOC, LLPs are considered to be non-filing entities.\textsuperscript{224} Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State\textsuperscript{225} an application accompanied by a fee for each partner of $200.\textsuperscript{226} The application must:

\begin{itemize}
  \item a. state the name of the partnership, the address of its principal office, the number of partners and the business in which the partnership engages, plus the federal tax identification number of the partnership; and
  \item b. be executed by a majority in interest of the partners, or someone authorized thereby.
\end{itemize}

The LLP is also required to include in its name the words "limited liability partnership" or an abbreviation thereof.\textsuperscript{227} Finally, LLPs are required to carry (i) at least $100,000 of errors and omissions liability insurance; or (ii) provide $100,000 specifically designated for the satisfaction of judgments against the partnership.\textsuperscript{228} A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a "LLLP."\textsuperscript{229}

IX. ABILITY TO RAISE CAPITAL/PROFITS AND LOSSES

The ease of access to public markets and the necessity of raising external financing can be significant factors to business owners.

A. Corporations

1. Various Capital Raising Devices Available

Corporations have the capacity to use a wide variety of equity and debt devices to raise capital.\textsuperscript{230} A corporation may issue shares in the amount and for

\textsuperscript{221} TBOC §§ 3.005, 3.010, 3.014.
\textsuperscript{222} TBOC § 5.056.
\textsuperscript{223} TBOC § 5.053.
\textsuperscript{224} See TBOC §§ 1.002(57), (34).
\textsuperscript{225} TBOC § 152.802.
\textsuperscript{226} TBOC § 4.158.
\textsuperscript{227} TBOC § 5.063.
\textsuperscript{228} TBOC § 152.804(a).
\textsuperscript{229} TBOC §§ 152.805, 1.002(47).
\textsuperscript{230} ROBERT W. HAMILTON, CORPORATIONS 356, 357-59 (7th ed. 2001).
such consideration, not less than the par value of such shares, as approved by its board of directors. Different classes and series of equity securities, with differing financial rights and preferential treatment, may be issued including, but not limited to, common and preferred stock. Corporations will often utilize other forms of securities that are convertible into or exercisable for capital stock (i.e., convertible debt, stock options or warrants).

2. Consideration for Shares

Shares may be issued for cash, promissory notes, services performed or any other tangible or intangible benefit to the corporation.

B. General Partnerships

1. Capital Raising Challenges

It is typically more difficult for a general partnership to effectively raise capital because:

a. the management of a general partnership is mostly decentralized;

b. general partnership interests are not freely transferable (with respect to management powers); and

c. the general partners are each subject to unlimited personal liability.

Normally, unless the partnership has specifically agreed otherwise, profits and losses of a general partnership are shared per capita and not in accordance with capital contributions or capital accounts.

C. Limited Partnerships

1. More Suitable than General Partnership for Raising Capital

A limited partnership provides a more suitable entity for raising capital than a general partnership, because, among other things, the limited partnership affords its limited partners individual liability protection and the entity has a more centralized management structure. Contributions to the partnership may consist of any tangible or intangible benefit to the limited partnership, although conditional contribution obligations are generally not enforceable until all conditions have been satisfied or waived. Absent any contrary provision in the written partnership agreement, profits and losses are allocated in accordance with partnership interests, or in the absence of such records, in proportion to the respective partners' capital accounts. Additionally, distributions representing a return of capital are made in accordance with the partners' respective capital contributions, and other distributions are made in proportion to the allocation of profits.

D. Limited Liability Companies

1. Attractive Entity for Raising Capital

The individual liability protections and centralized management options afforded to members of an LLC make the LLC form an attractive entity for raising capital. Generally, member contributions may consist of any tangible or intangible benefit to the LLC. Normally, an LLC Agreement will govern allocations of profits and losses, containing provisions comparable to those found in an LPA. If an LLC Agreement is otherwise silent, allocations and distributions are determined by mutual agreement as the values of the members respective contributions. By default, members are not entitled to receive distributions from the LLC prior to its winding up; although an LLC Agreement may allow for such distributions. However, to the extent that distributions are allowed, the liabilities of the LLC may not exceed the fair value of the LLC assets following the distribution. A member who has received a non-permitted distribution is only liable to return the distribution if the member knew that the distribution was prohibited. This limitation does not apply to payments for reasonable compensation, such as past or present services or payments made in the ordinary course of business or pursuant to a bona fide retirement or other benefits program.

E. Limited Liability Partnerships

The LLP entity generally enjoys similar benefits for raising capital as the LLC. As with the LLC, the LLP offers a more centralized management structure and affords limited liability protection to both its general and limited partners. In addition, under the TBOC, no partner of an LLP is individually liable for any other partner by contribution, indemnity, or otherwise for partnership obligations except as directed in the partnership agreement. Contributions to the partnership may consist of any tangible or intangible benefit to the limited partnership, although conditional contribution obligations are generally not enforceable until all conditions have been satisfied or waived. Absent any contrary provision in the written partnership agreement, profits and losses are allocated in accordance with partnership interests, or in the absence of such records, in proportion to the respective partners' capital accounts. Additionally, distributions representing a return of capital are made in accordance with the partners' respective capital contributions, and other distributions are made in proportion to the allocation of profits.

233 TBOC §21.159.
234 Egan, at 72.
235 TBOC § 152.202(c).
236 TBOC § 153.102
237 TBOC § 153.201.
239 TBOC § 153.206.
240 TBOC § 153.208.
241 TBOC § 1.002(9).
242 Egan, at 113.
244 TBOC § 101.204.
245 TBOC § 101.206.
246 TBOC § 101.206(d).
247 TBOC § 101.206(f) as amended in 2009 Legislative Session by S.B. 1442 § 41. See infra Appendix D.
X. TRANSFERABILITY OF OWNERSHIP INTERESTS

The ease with which interests in a business entity are transferred is often a key consideration when making a choice of entity determination.

A. Corporations

1. Shares Generally Freely Transferable

Shares of stock of a Texas corporation are generally freely transferable unless otherwise limited by contractual agreements such as a shareholders agreement or buy-sell agreement.

2. Restrictions on Transfer Permitted

Restrictions upon transfer are allowed under Texas law; however, any restrictions on transfer must be reasonable and any absolute restriction on transferability is void as a matter of law. The TBOC provides that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer. However, certain procedures must be followed to assure the enforceability of a share transfer restriction, such as the placement of a restrictive legend on the Company’s stock certificates.

B. General Partnerships

1. Differentiation Between Transfer of Partnership Interest and Admission as Partner

Texas law differentiates between the transfer of a partner’s partnership interest and the admission of a successor as a general partner. As a result, although partnership interests are transferable, generally, a partner may not assign its rights to participate in the management of a partnership without the consent of the other partners. Therefore, a transferee receiving a partnership interest is only entitled to receive, to the extent transferred, distributions to which the transferor would otherwise have been entitled. A transfer of a partnership interest is not considered an event of withdrawal and will not cause the winding up of a partnership. However, partnership agreements often contain a provision prohibiting any partner from assigning or transferring the economic rights associated with his partnership interest. General partnership interests may be evidenced by transferable certificates, but generally such interests remain uncertificated.

C. Limited Partnerships

1. Partnership Interests Generally Freely Transferable

Unless otherwise provided by the LPA, a partnership interest in a limited partnership is assignable in whole or in part. The assignment of the partnership interest will not, however, entitle the assignee to become, or to exercise the rights or powers of a partner unless the partnership agreement provides otherwise. Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled. If a general partner assigns all of his or her rights as a general partner, a majority in interest of the limited partners may terminate the assigning general partner’s status as a general partner. Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.

D. Limited Liability Companies

1. Membership Interests Freely Assignable

Unless otherwise provided for in the LLC Agreement, membership interests are assignable in whole or in part. An assignment generally does not automatically entitle an assignee to full membership rights. Instead, as with a partnership, the assignment of a membership interest entitles an assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled. Furthermore, the assignor continues to be liable and retains any unassigned membership rights. LLC Agreements typically contain restrictions on the assignment of interests to facilitate compliance with applicable securities and tax laws. Membership interest transfer restrictions contained in the LLC Agreement are enforceable.
XI. LIFE OF THE ENTITY

A. Corporations

1. Perpetual Existence Unless Charter Provides Otherwise

Under the TBOC, a corporation will have a perpetual existence unless otherwise indicated in its certificate of formation.\(^{267}\) Since a corporation is treated as a separate entity with continuity of life, events such as death or bankruptcy of an owner have no effect on the legal structure of a corporation absent a specific shareholder agreement attaching consequences and procedures for certain events. Even in bankruptcy, a shareholder continues to be a shareholder of the bankrupt entity. Shares can be passed down to heirs. Under the TBOC, all domestic entities exist perpetually unless otherwise provided in its governing documents.\(^{268}\) Thus, the perpetual existence of a corporation is not an advantage to be given much weight in determining the type of business entity to utilize, particularly since the TBOC governs all newly-formed entities.

B. General Partnerships

1. Winding Up Upon Occurrence of Certain Events

Under the TBOC, a partnership may be wound up upon an "event of withdrawal" or "event requiring a winding up."\(^{269}\) However, such an occurrence does not mandate that the partnership be wound up.\(^{270}\) An event of withdrawal occurs, among other events:

   a. upon the occurrence of events specified in the partnership agreement;
   b. when the partnership receives notice of a partner's election to withdraw;
   c. upon the expulsion of a partner by partner vote or judicial decree in statutorily specified circumstances; or
   d. upon the death or bankruptcy of a partner.\(^{271}\)

Except for the partner's right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement.\(^{272}\) Although a partner may withdraw from the partnership at any time, the withdrawal may subject the withdrawing partner to liability and various penalties if he or she violates the partnership agreement or the withdrawal is otherwise wrongful.\(^{273}\) Unless the partnership agreement provides otherwise,\(^{274}\) the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.\(^{275}\)

An event requiring a winding up occurs when, among other things, a majority in interest of the partners elect to wind up the partnership if the partnership does not have a specified duration, the term of the partnership expires, the partnership agreement calls for a winding up in a particular situation or all or substantially all of the assets of the partnership are sold outside the ordinary course of its business.\(^{276}\)

C. Limited Partnerships

1. No Perpetual Existence

Limited partnerships do not have an unlimited life to the same extent as a corporation, although the death or withdrawal of a limited partner or the assignment of a limited partnership interest will not affect the continuity of existence of the limited partnership, unless otherwise agreed or unless no limited partners remain.\(^{277}\) Under the TBOC, a limited partnership is required to commence winding up, upon the following:

   a. the occurrence of any event as specified in the partnership agreement;
   b. all of the partners of the limited partnership agree in writing to dissolve the limited partnership;
   c. an event of withdrawal of a general partner (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)\(^{278}\) absent certain circumstances; or
   d. a court of competent jurisdiction dissolves the partnership.

2. Partnership May Be Dissolved

A court may dissolve a partnership for the following reasons:

   a. the economic purpose of the partnership is likely to be unreasonably frustrated;
   b. a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the business in the partnership with that partner; or
   c. it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.\(^{279}\)

\(^{267}\) TBOC § 3.003.
\(^{268}\) Id.
\(^{269}\) TBOC §§ 11.051, 11.057, 152.501(b).
\(^{270}\) TBOC § 152.502.
\(^{271}\) TBOC § 152.501(b).
\(^{272}\) TBOC § 152.002.
\(^{273}\) TBOC § 152.503.
\(^{274}\) TBOC § 152.002.
However, upon the withdrawal of a general partner (unless the LPA otherwise provides),280 the limited partnership may continue its business without being wound up if: (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or partners or (ii) all (or a lesser percentage stated in the partnership agreement) remaining partners agree in writing to continue the business of the limited partnership within a specified period after the occurrence of the dissolution event and agree to the appointment, if necessary, of one or more new general partners.281

D. Limited Liability Companies

1. Winding Up Required Upon Occurrence of Certain Events

The TBOC requires that an LLC commence winding up its affairs upon the occurrence of any of the following events:

a. the expiration of the period (if any) fixed for its duration, which may be perpetual;282
b. any event specified in its certificate of formation or LLC Agreement to cause dissolution, or to require the winding up or termination, of the LLC;283

c. the action of the members to dissolve the LLC (in the absence of a specific provision in its certificate of formation or LLC Agreement, the vote will be by a majority of the members);284

d. the occurrence of any event that terminates the continued membership of the last remaining member of the LLC, absent certain circumstances;285

e. entry of decree of judicial dissolution under the TBOC.286

However, an LLC may in many cases cancel the event that would otherwise require dissolution of the LLC.287 If an LLC decides to terminate or dissolve, it shall: (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) send written notice of its intention to dissolve to each of its known creditors and claimants and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its members, before filing a certificate of termination with the Secretary of State.288 In the event a dissolving LLC’s assets are not sufficient to discharge its obligations, the LLC is required to apply the assets as far as they will go to the just and equitable payment of its obligations.289 Upon the filing of a certificate of termination with the Secretary of State, the existence of the LLC terminates except for the purpose of suits and other proceedings by members, managers and other LLC representatives.290

XII. SERIES LIMITED LIABILITY COMPANIES291

In addition to the other forms of entity previously discussed, Texas provides for the availability of a new form of entity - the series LLC.292 The IRS has attempted to provide formal guidance on the federal tax treatment of series LLCs in the form of Proposed Regulation Sections 301.6011-6, 301.6071-2, and 301.7701-1(a)(5) (the “Proposed Regulations”).

A series LLC is a form of entity that allows a single LLC to establish one or more series of members, managers, membership interests, or assets, each of which has separate rights, powers, or duties related to specified property or obligations of the LLC. Each series may have a separate business purpose or investment objective. A series LLC is expected to provide limited liability protection to the members of each series and eliminate the expense of forming multiple entities for members that want to segregate assets and liabilities of different activities.

A. Advantages of Using a Series LLC

1. Administrative Convenience

One of the principal benefits offered by series LLCs is administrative convenience and cost savings. Generally, one public document is filed with the appropriate state department for the series LLC. In Texas, the members can then designate new series without any additional public filings by preparing an addendum to the series LLC operating agreement.293

2. Avoidance of State Transfer Taxes

Some have also suggested that series LLCs can be used to avoid state transfer taxes. For example, if property is titled in the name of the series LLC,
theoretically, the property could be moved from series-to-series within that series LLC without having to change title, thereby avoiding state transfer taxes. This approach, however, seems risky. First, if the title to property is held by the series LLC rather than a particular series, there is a question about whether liabilities related to that property will truly be limited to a particular series. Second, in some states, a transfer tax may be triggered on an indirect ownership change. As a result, if there are different owners for each series, transferring property from one series to another may still trigger transfer taxes.

3. Investment Fund Blocker Entities

Series LLCs can also be used in the investment fund business when a blocker entity is needed for investments by foreign or tax-exempt investors. Generally, foreign and tax-exempt investors want to avoid investing in an operating partnership so that they can avoid earning income effectively connected with a U.S. trade or business ("ECI") or unrelated business taxable income ("UBTI"). Investment funds typically help investors avoid these "bad" categories of income by having those investors invest through a "blocker" entity that is taxed as a corporation for federal income tax purposes. The corporate "blocker" entity distributes dividends to its shareholders, which should not give rise to either ECI or UBTI. As an alternative to this structure, an investment fund could have investors invest in a series LLC. Each series within the series LLC would elect to be treated as a partnership or corporation as necessary, depending on whether the underlying investment is one that produces ECI or UBTI. This structure may provide a better alternative than setting up a single "blocker" with multiple investments because this structure provides investors with the opportunity to dispose of only one underlying investment at a time rather than just disposing of their investment in the single corporate "blocker." In addition, this structure may produce a better over-all tax result by avoiding corporate double-taxation wherever possible.

4. Limited Securities and Tax Filings

Finally, there may be additional administrative and cost savings benefits if series LLCs are able to limit securities and federal and state tax filings. With respect to securities filings, this approach is not without risk because it is not currently clear whether one securities filing is required from a series LLC or a securities filing will be required by each series of a series LLC. In addition, as discussed below, the Proposed Regulations will make it more difficult going forward to file one federal income tax return for a series LLC, rather than a return for each series within the series LLC.

### B. IRS Proposed Regulations

1. **Separate Entity Status and Ownership of a Series**

   Under the Proposed Regulations, each series of a series LLC will be treated as an entity formed under local law. Whether a series is recognized as a separate entity for federal tax purposes is determined under §301.7701-1 of the Treasury Regulations and general tax principals. As a result, each series that is recognized as a separate entity for federal tax purposes will be classified under the "check-the-box" regulations and may make any federal tax election it is otherwise eligible to make independently of the series LLC or any other series.

   For federal tax purposes, the ownership of a series and the assets associated with a series will be determined under general tax principles. The Proposed Regulations provide that, for federal tax purposes, the series LLC will not be the owner of a series or the assets associated with a series just because the series LLC holds legal title to such assets. Therefore, if a state statute does not permit a series to hold legal title to the assets associated with that series, then that series may still be considered the owner of those assets for federal tax purposes.

2. **Segregated Liability for Taxes**

   Because each series is treated as a separate entity formed under local law for federal tax purposes, each series should only be liable for federal income taxes related to that series. However, the IRS reserves the right to impose liability for taxes upon the series LLC or another series within such series LLC to the extent the debts of one series can be paid by the series LLC or another series within such series LLC under other provisions of local or federal law.

3. **Transition Rule**

   A taxpayer that has been treating all series within a series LLC as one entity for federal income tax purposes may continue to do so under the Proposed Regulations, by satisfying certain requirements.