How to Choose a Business Entity in Texas

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ABOUT THE AUTHOR

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As any experienced home builder knows, the key to a quality, long-lasting home is creating a solid foundation. Similarly, it is important for any business owner to seriously examine the different types of business entities prior to diving in to make sure the entity she chooses matches both her short and long-term needs. Although entities can be changed down the road, and sometimes must be in order to accommodate additional investors, the logistics and costs for doing so can be prohibitive for a fledgling small business. What follows is a brief overview of the different types of entities for a new business to choose from, as well as the advantages and disadvantages of each.

In Texas, the most commonly used types of business forms include:

- Sole Proprietorship
- General Partnership
- Limited Partnership
- Limited Liability Company
- S Corporation
- C Corporation

Sole Proprietorship

This is the most basic type of business entity and the default legal structure for a single person carrying on businesses operations without a partner. The main difference between this type of business structure and the remaining ones is that a sole proprietorship does not have a separate legal identity from its owner.

Advantages

It is inexpensive and allows a person to run her business without the formalities and legal complexities innate in a more complex business structure.

Disadvantages

The main problems are that a person's personal and business assets are commingled and there is no personal liability shield.

General Partnership

Under Texas law, a partnership is defined as an association of two or more persons to carry on a business for a profit, whether they intend to form a partnership or not. General partnerships are generally loosely governed, though founding documents can be drafted for more structure. In a general partnership, each partner has unlimited liability for the debts and obligations of the partnership.

Advantages

General partnerships can be very flexible and are regarded as pass through entities for income tax purposes.

Disadvantages

The main disadvantage of a general partnership is that the partners share unlimited liability. Another disadvantage is that general partnerships are not as stable as a corporation and most dissolve automatically when a general partner dies, resigns, or files for bankruptcy.

Limited Partnership

Limited Partnerships are similar to General Partnerships in almost all ways but one. As long as there at least one general partner, the remaining partners can be designated limited partners. As a limited partner, a person risks only the capital invested in the partnership and is generally not liable for the business debts beyond that amount. This status can be lost if the limited partner participates in the management in any meaningful way, however.

Advantages

Aside from the liability shield for limited partners, these entity forms also can provide for smooth interest succession with proper planning, such as family limited liability partnerships.

Disadvantages

The disadvantages for limited partnerships are largely the same as those for general partnerships. While many businesses use limited partnerships in conjunction with corporate structures, it is usually more difficult for limited partnerships to raise capital than for corporations.

Limited Liability Company

Limited Liability Companies combine the best attributes of partnerships and corporations and are the favored structure for small businesses in Texas. LLC's can be governed by appointed managers or members and have much flexibility in both governance and internal legal structure.

Advantages

LLC's provide liability protection for their members and enjoy pass-through status for taxing purposes. Membership interests are generally more easily transferable than partnership interests and their more clearly defined structures make them attractive for lending and investment purposes.

Disadvantages

There are few disadvantages to speak of, but their relative newness means that some of the more nuanced issues will have to work their way through the court system and legislative modifications are inevitable, those doubtfully retroactive.

S Corporation

An S corporation is a business corporation that has elected to be taxed under subchapter S rather than under subchapter C, the normal corporate tax section. This avoid double taxation common with C corporations. Certain restrictions apply for corporations wishing to take advantage of this election, eliminating most larger corporations from participation. In general, S corporations are owned by shareholders who elect directors to oversee big picture duties and appoint officers to run the day-to-day operations of the business. It is not unusual for these roles to intertwine in S corporations, due to their usual small ownership pool.

Advantages

One of the main reasons business owners incorporate is to create a liability shield, allowing them to risk only the capital invested and not their personal assets. Additionally, S corporations are separate entities and can exist in perpetuity. However, the tax advantage, centralized management feature, and ease of interest transfer make this entity form a popular choice for small business owners.

Disadvantages

S corporations can be expensive to set up and have the same registration fee as C corporations. Additionally, the requirements imposed by the Tax Code on these entities are restrictive and can stifle growth. With the advent of LLC’s, S Corporations have been dwindling in favor.

C Corporation

These entities are the bedrock of our financial system and the structure of choice for any group wishing to create a complex stock structure or entice serious funding. The general government of these entities is similar to that of S corporations, without the restrictions imposed for pass-through tax purposes.

Advantages

Like S corporations, C corporations provide a liability shield for shareholders, directors, and officers and can enjoy perpetual existence. Ownership interests in C corporations are of the most freely transferable types, subject to managing documents stating otherwise. As a separate entity, a C corporation can own property and sue in its own name.

Disadvantages

The main disadvantage of a C corporation is the upfront cost in formation and the amount of time and money needed to comply with legal requirements. Another disadvantage of this structure is double taxation of income, both at an entity and shareholder level.

Choosing a business entity through which to operate your entrepreneurial aspiration is one step along the process that should not be taken lightly. Speak with an experienced small business attorney if you wrestling with this issue, as many exceptions and minor qualifications apply throughout these structures which could have a significant impact on your particular business model.