CHOICE OF BUSINESS ENTITY IN TEXAS

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I. Introduction

80 to 90 percent of businesses in the United States are small, family owned businesses. These small businesses account for 49 percent of the gross national product and employ 59 percent of the workforce in the United States.[1] When advising these small businesses regarding choice of entity, the professional advisor must consider and balance the following goals of the small business owner: 1) liability protection; 2) maintenance of control over the operation and assets of the business; 3) minimization of income and other related taxes; 4) maximization of valuation discounts for transfer tax purposes.[2] Additionally, planning for the death or incapacity of the business owner is critical to the growth, value, and longevity of the business.

II. What business entity best suits the needs and purpose of my client's business?

A. Who is my client and why does it matter?

When determining how to advise your clients regarding choice of business entity, understanding who you represent sets the foundation for further analysis. Under the Texas Rules of Disciplinary Conduct, an attorney may not represent a person if the interests of such person are, appear to be, or become "materially and directly adverse to the interests of another client."[3]

Often times, owners of fledgling startups seek the counsel of one attorney due to capital restraints. As long as the interests of such owners remain aligned, representing multiple parties in the formation of a business entity should not create a conflict of interest problem for the attorney. However, once a conflict arises, the attorney must withdraw representation unless the attorney "reasonably believes the representation will not be" adversely affected by such conflict and the clients give informed consent to such representation.[4]

When advising the owners of a business regarding choice of entity, it is probably naive to believe that the common representation of business owners by a single attorney will result in the zealous representation of each client in the formation of a business. However, if the attorney reasonably believes that such representation will not materially adversely affect the representation of each party and "each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common

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[1]Justin B. Goldstein, *How to Succeed in Family Business: Human Issues Facing Succession of Family Owned Businesses*, 4 No. 6 LAWYERS J. 5, March 22, 2002.

[2]Charles M. Hornberger, *Choice of Entity for Small Businesses*, Presented at the Advanced Estate Planning and Probate Law Course, State Bar of Texas, Austin, Texas, June 3-5 (1998).

[3]TEX. DISCIPLINARY R. PROF. CONDUCT 1.06 (1989) *reprinted* in TEX. GOVT CODE ANN., tit. 2, subtit. G, app. (Vernon Supp. 1995).

[4]*See* MODEL R. OF PROF. CONDUCT 1.7(a)(2), 1.7(b)(2) (1983). *See also* Dzienkowski, John S., *Positional Conflicts of Interest*, 71 TEX. L. REV. 457 (1993).

representation and the advantages involved," the attorney may continue representation.[5]

Many tricky issues spring from the representation of multiple parties in any business planning matter. For example, clients normally expect attorney-client communications to be confidential. However, if the attorney represents more than one individual in a related matter, then engages in a communication with one client and is given information that might be potentially harmful to the other client, the attorney must either withdraw representation or divulge the potential harmful information to the affected client, with the permission of the client who communicated such potentially harmful information.[6]

Explaining the possible conflicts for each client and setting out the rules for the multiple party representation in an engagement letter signed by the client is a necessary first step in the representation of multiple parties to a related matter. See Appendix A for an example of such letter.

B. Explore the Non-tax Related Choice of Entity Issues

When forming a business structure, an analysis of the non-tax related issues should be done separately from the analysis of tax related issues. The check-the-box regulations greatly expanded the business owner's options regarding choice of business entity and, as a consequence, have increased the importance of analyzing non-tax related issues.[7]

1. Benefits of a Limited Liability Shield

Naturally, once a business owner hires employees or takes on a partner, the business owner becomes concerned about protecting his personal assets from the liabilities of his business. Almost every business owner will benefit from shielding his personal assets from the liabilities of the business via the operation of the business within a business entity that provides, via statute, such protection. The only business owner who may not benefit greatly from a limited liability shield is the sole proprietor who does not have employees. This follows because a sole proprietor without employees is exposed to individual liability for his own personal torts or professional malpractice, even if such actions are done on behalf of or in the scope of his duties as the business owner.[8]

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[5]TEX. DISCIPLINARY R. PROF. CONDUCT1.06 (1989) *reprinted* in TEX. GOVT CODE ANN., tit. 2, subtit. G, app. (Vernon Supp. 1995).

[6]Henry S. Drinker, Legal Ethics 112 (1953). "When the interests of clients diverge and become antagonistic, their lawyer must be absolutely impartial between them, which, unless they both or all desire him to represent them both or all, usually means that he may represent none of them."

[7]*See* Darcy C. Blossfeld, *Effect of New Federal Tax Regulations on LLC's*, 61 TEX. B.J. 121 (1998)(*discussing* how the check the box regulations provide more certainty as to the tax treatment of unincorporated businesses and will increase the number of businesses choosing to do business as an unincorporated business organization.)

[8]*See* William J. Rands, *Passthrough Entities and their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15 (1995). "The concept of limited liability does not insulate

2. Transferability of Interests. While most entrepreneurs are familiar with the veil of protection offered by the corporate form, lesser known and understood issues involving the transferability of business interest may be just as important. In addition to shareholder agreements, partnership agreements, and limited liability company regulations, state and federal laws govern the transferability of business interests.

The choice of business entity impacts upon the transfer of business interests in the event of a stakeholder's disability, death, divorce, and exit from the business. While each form of business entity manages these issues in a unique way, the governing documents of any business entity should address the following transferability of interest issues: 1) Who is a permissible successor stakeholder in the event of a death, incapacity, divorce, or exit of an interest holder? and 2) How should a stakeholder's interest be valued in the event a stakeholder wants to sell his or her interest or in the event the stakeholder dies, becomes divorced, is disabled, or is separated from his or her employment with the business?

In addition to carefully crafting the governing documents of the business entity relating to the transferability of business interests, the well advised business owner will consider the state and federal laws governing the transferability of business interests as those laws relate to each business entity. For example, if a stakeholder becomes the target of a judgment creditor, the choice of business entity will affect whether the judgment creditor may gain control over such stakeholder's interest or be limited to an income interest in the stakeholder's interest in the business.

3. Management Structure. Another important non-tax issue to resolve when selecting a business form relates to the management structure of the business form. Key considerations with regard to the management structure of a business include: 1) whether control of the business will be tied to equity interests;[9] 2) whether control of the business will be centralized or diffused; and 3) how control of the business is transferred.

III. Overview of Forms of Business Entities

A. Sole Proprietorship/General Partnership

1. Formation. The sole proprietorship or general partnership is formed when one or more individuals go into business. No other action is needed. If the business is conducted under an assumed name, then the business owner(s) must file an assumed name certificate and obtain an employer identification number from the IRS.

2. Liability Protection. Neither the sole proprietorship nor the general partnership offers liability protection to the business owners.

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shareholders, members, or anyone else from personal liabilities for any torts that they themselves commit while working for the business." *Id* at 26.

[9]Adrienne Randle Bond, *Entity Selection and Other Issues Facing Startup Ventures* (July 2001)(unpublished manuscript on file with the University of Houston Law Foundation).

3. Formalities. The sole proprietorship and general partnership are alter egos of the business owners. Consequently, no observation of formalities is required.

4. Taxation. The taxation of sole proprietorships and general partnerships is very simple because sole proprietorships are disregarded entities and general partnerships offer flow through taxation of all profits and losses straight to the owners of the business Additionally, neither the sole proprietorship nor the general partnership are subject to franchise tax in the State of Texas.

5. Common Uses. Businesses that typically benefit from being structured as a sole proprietorship or general partnership include very small businesses where the business owns assets of little value and where the business owners perform the activities of the business or the business owners hire independent contractors to perform the activities of the business. Once the business takes on employees or begins to accumulate assets, the business owner should consider doing business as a statutorily created business entity to limit his exposure to the liabilities of the business and/or to protect the assets of the business from his individual liabilities.

6. Limited Liability Partnership. A general partnership may elect to become a limited liability partnership by filing a statement providing the following information: 1) the name of the partnership; 2) the federal tax identification number of the partnership; 3) the street address of its principal office in Texas and outside the state, if applicable; 4) the number of partners at the date of application; and 5) a brief statement of the business in which the partnership engages.

A partner's liability in a registered limited liability partnership differs from that in an ordinary partnership. In a registered limited liability partnership, a partner is not individually liable for debts and obligations of the partnership incurred while the partnership is a registered limited liability partnership, nor is the partner liable for tortious acts committed by other partners. However, each partner is exposed to unlimited liability for torts of the partnership. For example, if the partnership owns a building and fails to maintain it and, as a consequence, a person is injured and seeks a judgment against the partnership, each partner is exposed to individual liability.

B. Corporation

1. Formation. A Texas corporation can only be created by filing articles of incorporation with the Texas Secretary of State. Texas corporations are governed by the Texas Business Corporation Act.[10]

2. Liability Protection. A corporation does provide limited liability for its shareholders such that shareholders' liability is limited to each shareholder's interest in the corporation.[11] Consequently, the recovery of a judgment creditor of a corporation is limited to the

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[10]TEX. BUS. CORP. ACT ANN. art. 1.01 (Vernon Supp. 2002).

[11]*See* James Gerard Gaspard, II, *A Texas Guide to Piercing and Preserving the Corporate Veil*, 31-SEP BULL. BUS. L. SEC. ST. B. TEX. 24, 25 (September 1994)(*explaining* that "limited liability means that corporate shareholders are responsible for the corporation's liabilities only to the extent of their investment in the corporation).

assets of the corporation. In other words, the corporation is responsible for its own debts and torts, not the shareholders.[12] The individual assets of the shareholders may not be used to satisfy the judgment creditor of a corporation, provided the corporate structure is respected by the shareholders and the courts. While the limited liability protection a corporation offers to its shareholders is a fundamental attribute of the corporate form, three important exceptions exist.

a. No Business Asset Protection. First, an often ignored drawback of the corporate form involves business asset protection. Business asset protection is the protection of business assets from the individual liabilities of the business owners. Liability protection does not extend to the assets of the corporation, as the shares owned by a shareholder may be attached by a judgment creditor of a shareholder. If the shareholder owned a controlling interest in the corporation and the judgment creditor satisfied the judgement with the controlling shares of the corporation, the judgment creditor of the individual shareholder could gain control of the business. The creditor could then ultimately run the corporation and sell off all the corporation's assets to satisfy the judgment.

b. Piercing the Corporate Veil. Second, another exception to the doctrine that the corporate form will protect shareholders from the liabilities of the corporation involves piercing the corporate veil. "'Piercing the corporate veil," or "disregarding the corporate entity," refers to the judicially imposed exception to the principle of limited liability by which courts disregard the separateness of the corporation and hold a shareholder responsible for the corporation's action as if it were the shareholder's own."[13]

Texas courts distinguish between claims arising from tortuous actions and claims arising out of a contract. If the claim involves a tort, the plaintiff need not show that the corporation acted in a fraudulent manner. However, if the claim involves a contract dispute, the plaintiff's burden of proof is elevated because the plaintiff must show actual fraud.[14] The theory behind this distinction arises from the belief that in a tort case, the relationship with the corporation is involuntary; and in the case of a contract, the relationship with the corporation is voluntary.[15]

The courts in Texas have disregarded the corporate form under the following theories: 1) the corporation form is used as a means to perpetrate fraud; 2) the corporation is organized and operated as a mere tool or business conduit of another corporation; 3) the corporate form is used to evade an existing legal obligation; 4) the corporate form is used to perpetrate monopoly; 5) the corporate form is used to circumvent statute; and 6) the corporate form is used to justify wrongdoing.[16]

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[12]*Id.*

[13]*Id* at 25. See also Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

[14]TEX. BUS. CORP. ACT ANN. art. 2.21 (Vernon Supp. 2002).

[15]*See* Gaspard, *supra* note 11, at 28.

[16]*See Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986).

3. Formalities. In order for the corporate structure to be respected by the courts and prevent the corporate veil from being pierced, the shareholders should observe corporate formalities. Specifically, the corporation should, *inter alia*: 1) keep the minute book up to date by including minutes of annual and special meetings; 2) maintain financial records separately from the individual shareholders; 3) issue stock certificates; 4) adhere to the bylaws; 5) maintain the stock ledger; 6) hold directors meetings to approve large expenditures, long-term leases, and compensation plans; 7) insure that the corporation is adequately capitalized and insured; and 8) avoid transactions involving self-dealing.[17]

4. Taxation. All corporations are subject to franchise tax in Texas. A corporation must pay franchise taxes equal to the greater of .25% of the net capital of the corporation or 4.5% of the net taxable earned surplus. No franchise tax is due if the corporation: 1) had no gross receipts in the State of Texas; 2) had total gross receipts of less than $150,000; or 3) had total taxable capital of less than $40,000 and its earned surplus totaled less than $2,222.

Under federal law, a corporation may be taxed as a corporation under subchapter C of the Internal Revenue Code or as a pass through entity under subchapter S of the Internal Revenue Code.

a. C Corporation. Unless the corporation elects otherwise, it will be taxed under subchapter C of the Internal Revenue Code. Consequently, the net income of the corporation will be subject to income tax at the corporate level. If the net income is distributed to shareholders and not added to the retained earnings of the corporation, the shareholders must pay income tax on the dividend, resulting in what many practitioners refer to as "double taxation." Some individuals get around this double taxation issue by taking the net income out of the corporate entity as wages. These wages are a deduction to the corporation and income to the shareholder employee.

b. S Corporation. If a corporation makes an election with the IRS on Form 2553 to be taxed as a subchapter S corporation, then the corporation will be taxed as a flow through entity. The Form 2553 must be filed: 1) at any time on or before the 15th day of the third month of the tax year; or 2) at any time during the preceding tax year.[18] Often times, practitioners interpret the 15th day of the third month to mean 75 days. However, if a corporation is formed, say on January 31, the Form 2553 is due by March 15th, which could give the tax professional as few as 42 days to file the election in a leap year.

A corporation must have the following characteristics in order to qualify for subchapter S tax treatment: 1) it is a domestic corporation; 2) it has no more than 75 shareholders;[19] 3) the shareholders are individuals, estates, certain exempt organizations, or qualified subchapter S trusts; 4) no nonresident aliens are shareholders; 5) it has only one class of stock; and 6) it has a tax year

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[17]*See* Gaspard, *supra* note 11, at 53-54.

[18]*See* instructions to I.R.S. Form 2553.

[19]A husband and wife, and their estates are treated as one shareholder for the purposes of qualifying the corporation for subchapter S tax treatment.

ending December 31, unless electing otherwise.[20]

The taxation regime outlined in subchapter S of the Internal Revenue Code allows flow through taxation so that the net profits of the corporation flow straight to the shareholders' individual income tax return instead of being first taxed at the corporate level. Generally, the S corporation enables shareholders to receive a reasonable salary and then take the remaining profits as net income subject only to income tax, not social security and medicare taxes. However, the benefits associated with taking the profits out of the S corporation without those profits being subject to social security and medicare taxes must be balanced against the franchise tax. So, if a shareholder does not take the net income of a corporation in salary, which is deductible to a corporation, and pay the appropriate social security and medicare taxes (which social security wage base is $87,000 in 2003[21] while the 2.9% medicare tax wage base is unlimited),[22] then such shareholder could pay 4.5% in franchise tax[23] on the net income earned in a corporation, as compared to only 2.9% in medicare tax on the wages paid out of a corporation.

5. Common Uses. The C corporation is frequently used by business owners seeking venture capital, planning to go public, anticipating much growth, seeking to increase the value of the business, and/or requiring the maintenance of a large capital base by the corporation (for research and development, as an example). Small businesses often operate as S corporations.

6. Other Types of Corporations

a. Professional Corporation. The professional corporation is formed by filing articles of incorporation with the Texas Secretary of State and setting out inside the articles that the corporation is a professional corporation. The professional corporation is governed by the Texas Professional Corporation Act.[24] The professional corporation may be taxed as either a C corporation or an S corporation. Business owners may form professional corporations if they are professional service providers such as attorneys, architects, CPAs, etc. The professional corporation does not offer limited liability protection for the professional malpractice of the shareholder. However, the business owner enjoys limited liability for claims accruing from sources other than the business owner's own activity. For example, if a client of the business owner suffers injury from a fall in the business owner's office, the business owner will be shielded from personal liability, so long as the fall did not result from the business owner's own negligence.

b. Professional Association. The professional association is formed by filing articles of association with the Texas Secretary of State and it is governed by the Texas Professional

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[20]*See* IRC §§1361, 1362, 1378. *See also* Treas. Regs. 1.444-3T(b)(3).

[21]67 Fed. Reg. 65,620 (October 25, 2002).

[22]IRC §§ 3101(b), 3111(b), and 3121(a)(1).

[23]TEX. TAX CODE ANN. §171.002 (Vernon 1992)

[24]TEX. REV. CIV. STAT. ANN. art. 1528e, §3(d) (Vernon 1997).

Association Act.[25] The professional association may be taxed as either a C corporation or an S corporation. The professional association *is not* subject to franchise tax in Texas. The types of individuals that can form a professional association are only those persons duly licensed to practice a profession, including: podiatry, dentistry, optometry or therapeutic optometry, or chiropractic medicine. Again, this type of entity does not offer limited liability protection for the professional malpractice of the shareholder. However, like the professional corporation, the business owner enjoys limited liability for claims accruing from sources other than the business owner's own activity.

c. Nonprofit Corporation. The nonprofit corporation is formed by filing articles of incorporation for a Texas nonprofit corporation with the Texas Secretary of State. If the nonprofit seeks to be exempt from state and federal taxation, the corporation must file a Form 1023 Application for Recognition of Exemption with the IRS and pay a user fee amounting to $150 if gross receipts will average less than $10,000 per year for five years, or $500 if gross receipts are expected to average more than $10,000 per year. If the application is approved, then the nonprofit will receive a determination letter or advanced ruling from the IRS. If the nonprofit seeks tax exempt status with the State of Texas, the nonprofit must file a statement of activities with the Texas Comptroller of Public Accounts and enclose the determination letter or advanced ruling received by the IRS.

Upon formation, all the officers and directors of a nonprofit enjoy limited liability so long as their actions do not constitute a breach of the fiduciary duty of loyalty to the nonprofit corporation.

Generally, as long as the nonprofit corporation receives tax exempt status from the IRS, it is not subject to federal income tax and so long as the nonprofit corporation receives tax exempt status from the Texas Comptroller of Public Accounts it is not subject to sales or franchise tax. Three important exceptions exist to this rule. First, unrelated business income, which is income received that is not in furtherance of the nonprofit's tax exempt purpose, is subject to income tax. Second, the nonprofit must pay employment taxes. Third, the nonprofit must also pay property tax unless the real property is used in furtherance of its exempt purpose.

Additionally, if a nonprofit's gross receipts total more than $25,000 and it is not a church or other organization exempt from filing, then the nonprofit is required to file annual returns with the IRS. Such filings are done on Form 990.

C. Limited Liability Company

1. Formation. The limited liability company is formed by filing articles of organization with the Texas Secretary of State and it is governed by the Texas Limited Liability Company Act.[26]

2. Liability Protection. Like the corporation, the limited liability company offers limited liability protection to its members, such that each member's liability is limited to each member's interest in the limited liability company. Consequently, if a liability accrues within the limited liability company, then the members' personal assets will be protected from a judgment creditor of the limited liability company, provided that the company form was respected by the

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[25]TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon 1997).

[26]TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon 1997).

members and the courts.

a. Business Asset Protection. Perhaps the most important difference between the corporation and the limited liability company relates to business asset protection. In the event a judgment creditor of a member of a limited liability company seeks to satisfy such judgment with such member' interest in a limited liability company, the creditor will obtain only the rights of an assignee. This assignee interest does not give a creditor voting rights nor does it give a creditor the power to force a distribution on such interest. As a result, the limited liability company and its assets are protected from the judgment creditors of its members.

b. Piercing the Company Veil. The same theories that apply to a corporation with regard to piercing the corporate veil likely apply to a limited liability company.[27]

3. Formalities. Like a corporation, in order for the company form to be respected by the courts, thereby shielding members from company liabilities, the members must adhere to the formalities of operating a limited liability company. The formalities associated with the limited liability company are similar to the formalities associated with a corporation, with one relatively important difference. If the limited liability company is taxed as a disregarded entity or partnership, minutes of annual and special meetings are unnecessary. However, most practitioners encourage business owners to conduct annual and special meetings even if they are not required.

4. Taxation. With an limited liability company, it is possible to have several different structures for taxation. A breakdown is as follows:

a. Sole Proprietorship. By default, if a single person or entity forms a limited liability company, then the taxation of such limited liability company will be deemed to be disregarded and the limited liability company will be taxed as a sole proprietorship if the member of the limited liability company is an individual, or it will be taxed as a branch or division of the entity owner. This type of taxation results in all of the limited liability company's income and expenses being reported on the individual or entity's income tax return.[28] While the limited liability company is a disregarded entity for tax purposes, it is not disregarded under state law, affording the members the benefits associated with limited liability.

b. Partnership. By default, if two or more single persons or entities form a

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[27]*See* David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company*, 51 OKLA. L. REV. 47, 429 (1998) (*applying* current law on veil piercing to the limited liability company). *See also* Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1145 (1994)(*arguing* that many of the existing theories of veil piercing should be applied to the limited liability company).

[28]Treas. Regs. §301.7701-3(b)(1).

limited liability company, then the taxation of such limited liability company will be deemed to be a partnership and the limited liability company will be required to file a Form 1065 tax return.

c. C Corporation. A limited liability company, after formation, may elect to be taxed as a corporation by filing Form 8832 Entity Classification Election and checking the box choosing to be taxed as an association taxable as a corporation. As a result, net income earned by the limited liability company will be taxed inside the limited liability company at the lower corporate tax rate. Like a corporation, a limited liability company making this election is required to file income tax Form 1120.

d. S Corporation. If the limited liability company files Form 8832, electing to be taxed as an association taxable as a corporation, and Form 2553, electing to be taxed under subchapter S of the IRC, then the limited liability company will be taxed as a subchapter S corporation. Like a subchapter S corporation, the limited liability company making these elections is required to file income tax Form 1120S.

5. Common Uses. The Limited Liability Company is frequently used by business owners, small or large, who seek limited liability protection along with business asset protection, in a simple or complex type of entity.

6. Professional Limited Liability Company. The limited liability company will be deemed to be a professional limited liability company if the members file articles of organization which state that the company is a professional limited liability company formed for the purpose of rendering professional services by individuals licensed in any type of professional service which requires as a condition precedent to the rendering of such service the obtaining of a license, permit, or certificate. Examples of such professional service providers include: architects, attorneys, certified public accountants, dentists, public accountants, and veterinarians.

D. Limited Partnership

1. Formation. A limited partnership is created by filing a certificate of limited partnership with the Texas Secretary of State.

2. Liability Protection. A limited partnership does provide limited liability to its limited partners, such that each limited partner's liability is limited to such partner's interest in the limited partnership. However, the general partner of a limited partnership is personally liable for the liabilities of the limited partnership. Consequently, if the limited partnership will own assets giving rise to liability exposure, the well advised business owner will not serve as the general partner of the partnership, individually. Rather, such business owner will form another business entity such as a limited liability company or a corporation to serve as the general partner of the limited partnership, shielding the business owner from personal liability. When selecting a business entity to be used as the general partner of a limited partnership, most practitioners favor the use of the limited liability company over the corporation because the limited liability company provides business asset protection, which protects the assets of a business from the individual liabilities of its stakeholders.

a. Business Asset Protection. Like the limited liability company, the assets of the limited partnership are protected from the judgment creditors of the limited partners. If a judgment creditor of a limited partner seeks to satisfy such judgment with the limited partner's interest in the limited partnership, the judgment creditor is treated as having the same rights as an assignee.

b. Piercing the Partnership Veil. Little authority exists on the issue of whether the partnership veil may be pierced so that limited partners are exposed to personal liability for the wrongdoings of the limited partnership. However, practitioners suggest that piercing the partnership veil is likely not a remedy available to the judgment creditors of a limited partnership.[29]

3. Formalities. As with any other type of entity, the structure of the limited partnership must be respected by its partners. If it is respected, then the limited partners' personal assets will be protected from a lawsuit. To insure the protection afforded to the limited partners, the partners must adhere to the formal requirements of the limited partnership. This involves keeping all limited partnership income and expenses separate from the partners' personal income and expenses.

4. Taxation. Limited partnerships do not pay Texas franchise tax. Federal partnership taxation is governed by subchapter K of the Internal Revenue Code. The partnership is required to file Form 1065 and issue a K-1 to each partner, setting out each partner's share of partnership net income or loss. The taxation of a limited partnership is often referred to as "flow through" or "conduit" taxation because net income and losses are not taxed at the partnership level, rather, net income and losses flow through to the partners and are reported by the partners on their individual income tax returns. While subchapter S corporations and partnerships both offer flow through taxation, key differences make taxation under subchapter K preferable in many cases.

Partnership taxation offers unique flexibility with regard to the distribution of income and losses to the partners.[30] Most of this flexibility springs from Section 704 of the Internal Revenue Code, which allows a partner's distributive share of each income or loss to be determined by the partnership agreement.[31] Therefore a partner's distributive share need not be the same for each item. For example, an item producing income can be allocated to a partner with losses from outside the venture, and any item producing losses can be allocated to a partner with income from external sources."[32] However, such allocation will be re-allocated in proportion to the partner's interest in

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[29]*See* Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 461 (1977)(*explaining* that "piercing a thinly capitalized limited partnership has apparently not been a creditor remedy if the limited partner does not participate in the control of the partnership business").

[30]*See* Lee A. Sheppard, *Partnerships, Consolidated Returns, and Cognitive Dissonance*, 63 TAX NOTES 936 (1994).

[31]I.R.C. §704(a).

[32]Rands, *supra* note 8, at 18-19.

the partnership if the allocation does not have "substantial economic effect."[33] Subchapter S does not provide this type of flexibility in the allocation of income and loss.

Another key advantage of taxation under subchapter K involves the addition of partnership liabilities to the basis of the limited partners. Under subchapter K, as the partnership takes on debt, each partner's basis will be increased by such partner's proportionate share of the debt.[34] Again, subchapter S does not allow the shareholders of an S corporation to increase their basis in the corporate stock when the corporation takes on liabilities. As a result, highly leveraged businesses prefer the use of the limited partnership over the S corporation.

5. Common Uses. Families often use limited partnerships for estate planning and asset protection purposes. This topic will be addressed at length later in the outline. Additionally, businesses seeking to avoid franchise tax and businesses that are highly leveraged use the limited partnership. Finally, the limited partnership is attractive to profitable businesses that plan to distribute most of the profits to investors.[35]

IV. When is Converting a Client's Business Form Appropriate?

A. What are the Benefits Associated with Conversion?

For many businesses exploring the possibility of converting a business entity from a C or an S corporation to a limited partnership, the following benefits are sought: 1) exemption from franchise tax; 2) business asset protection; and 3) compression in value of business for transfer tax purposes. Under the Texas Business Corporation Act, a corporation may convert to a limited partnership.[36] Immediately after the conversion, the limited partnership may elect under the check-the-box regulations[37] to be treated as a corporation by filing Form 8832. If the limited partnership (converted entity) elects to be taxed as a corporation, the conversion of the corporation to a limited partnership should be deemed a tax-free F reorganization, which is a mere change in identity, form, or place of organization of a corporation. The converted entity will inherit the federal tax attributes of the former corporation including: taxable year, employer identification number, and other tax elections.

1. Franchise Taxes. When a closely held corporation or limited liability company is paying high franchise taxes, such business might consider converting to a limited partnership to avoid the franchise tax. For years, Texas legislators have introduced amendments to Section 171.001 of the Texas Tax Code to subject limited partnerships to taxation. Yvonne Davis, a legislator from Dallas, Texas, recently introduced House Bill 894 which proposed to amend Section 171.001(b)(3)

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[33]I.R.C. §704(b).

[34]I.R.C. §§772, 752(a).

[35]*See* Rands, *supra* note 8, at 17.

[36]TEX. BUS. CORP. ACT ANN. art. 5.17, (Vernon 1997).

[37]Treas. Reg. §301.7701-3(a).

to change the definition of "corporation." The bill proposes to include in the definition of "corporation" "a business trust, limited liability company, or other entity that, for federal income tax purposes, is classified as a corporation . . ."[38] If this bill passes, the number of conversions of corporations to limited partnerships motivated by the avoidance of the Texas franchise tax will taper off.

2. Asset Protection. When the shareholders of a closely held corporation seek business asset protection, then such shareholders might consider converting to a limited liability company or limited partnership under Texas state law. As previously discussed, such entities offer superior asset protection capabilities compared to a corporation because the assets of the limited partnership and the limited liability company are protected from attachment by the judgment creditor of a limited partner or member. The superior asset protection attributes offered by the limited liability company and the limited partnership will be discussed at length later in this outline.

3. Compression in Value of Business Interests. It is possible to obtain a greater compression in value of the assets inside a corporation if such corporation is converted to a limited partnership. This compression in value is due to the discounts a limited partnership interest receives as compared to a corporation. For example, a corporation might receive a discount for a block of shares owned by a shareholder if those shares represent a minority interest in the corporation. With a limited partnership, a limited partner can own a majority of the interests in such entity and still receive valuation discounts for lack of marketability, lack of control and lack of liquidity. These discounts ultimately give the interests owned by the limited partner a higher discount in value for transfer tax purposes in relation to the discounts achieved with the corporation's minority shareholder's block of stock.

B. Steps to Performing a Conversion in Texas:

1. Determine What Type of Entity You Are Converting and How it Is Taxed.

2. Determine Your Goal in Converting. Is the main goal to reduce franchise taxes, obtain better asset protection, or receive a compression in value?

3. Structure Requirements for Different Entities:

a. Conversion of S Corporation into Limited Partnership. If an S corporation seeks to maintain its subchapter S status at the federal level while converting to a limited partnership with a limited liability company as a general partner at the state level, the limited liability company must be a single member limited liability company and, as a consequence, a disregarded entity at the federal level. If the limited liability company has more than one member, it will not be a disregarded entity for federal tax purposes. Rather, the multiple member limited liability company must be treated as either a corporation, S corporation, or partnership for federal tax purposes, and none of those entities are permitted shareholders of a subchapter S corporation.

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[38]Tex. H.B. 694, 78th Leg., 1st C.S.

After creation, the limited partnership must file Form 8832, electing to be taxed as an association taxable as a corporation, and Form 2553, electing to be taxed as a subchapter S corporation. This election will continue the prior taxation of the converted entity.

While the IRS has previously sanctioned the conversion of an S corporation into a limited partnership with a limited liability company as the general partner in a private letter ruling,[39] it is currently unclear whether the IRS will determine that a business converting from an S corporation into limited partnership with a limited liability company as general partner for state tax purposes may maintain its subchapter S status for federal tax purposes. In a recent publication of revenue procedure, the IRS hinted that a limited partnership with a limited liability company as general partner might be deemed to have two classes of stock and fail to qualify for subchapter S tax treatment.[40]

In light of the uncertainty the IRS has raised by their "no rule" policy on the issue of whether a limited partnership has two classes of stock, a more cautious, yet less direct approach might be to convert the S corporation to a Texas general partnership which elects to be taxed as an association taxable as a subchapter S corporation. Before such a conversion takes place, however, the S corporation should contribute all of its assets to a Texas limited partnership in which a limited liability company is the general partner. In exchange, the S corporation would receive a 99% limited partnership interest in the new limited partnership. After transferring the assets and receiving the limited partnership interests, the S corporation, whose primary asset is a 99% interest in the Texas limited partnership, should convert to a Texas general partnership. The resulting conversion should: 1) qualify as a tax-free F reorganization; 2) avoid the second class of stock issue raised by Rev. Proc. 99-51, 1999-52 IRB 760; and 3) provide the general partners of the converted entity (who are the former shareholders of the S corporation) with the limited liability of a limited partnership.

b. Conversion of C Corporation into Limited Partnership. The conversion of a C corporation is similar to the conversion of an S corporation except that Form 2553 need not be filed. Additionally, the second class of stock issue is irrelevant. It is important that the limited partnership (converted entity) maintain the same tax attributes as the C corporation (converting entity) by filing Form 8832 to avoid a liquidation event.

c. Conversion of S Corporation into Limited Liability Company. If an S corporation, seeking to enhance its liability protection, converts to a limited liability company, the limited liability company must File for 8832 and Form 2553 to continue the tax attributes of the S

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[39]*See* P.L.R 199942009 (*providing* that a converted entity structured as an LP with an LLC general partner will not constitute more than one class of stock for purposes of §1361(b)(1)(D) as long as all partners have identical rights to partnership distributions and liquidation proceeds under the partnership agreement).

[40]*See* Rev. Proc. 99-51, 1999-52 IRB 760. *See also* §5.05 of Rev. Proc. 2001-3, 2001-1 I.R.B. 111 "[On] whether a state law limited partnership electing under § 301.7701-3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D), the service will treat any request for a ruling on whether a state law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership complies with §1361(b)(1)(D)."

corporation (the converting entity) and avoid a liquidation event.

d. Conversion of Sole Proprietorship or General Partnership. With a partnership or sole proprietorship, the dissolution of the previous entity and the contribution into a new entity's assets will be deemed a nontaxable event and no special filings such as articles of conversion are needed to be filed with the secretary of state.

V. Asset Protection and the Small Business Owner

Asset protection is a growing concern for the small business owner, especially where the legal climate seems to charge the deeper pocket, not the most culpable.[41] In the past, business owners increased insurance coverage in an attempt to hedge liability exposure. With the advent of outrageous jury verdicts and the resulting increase in the price of insurance coverage, business owners are looking for other methods to protect assets.[42] Three themes dominate asset protection planning: 1) invest in assets that are exempt from creditors; 2) isolate assets to insulate them from the liability exposure of other assets; 3) structure business entities to make them unattractive to creditors.

A. Investing in Exempt Assets

The small business owner's first line of defense against potential liability exposure involves his investment decisions. Specifically, the small business owner wishing to protect himself and his family from liability exposure should maximize his investment in exempt assets. In Texas, exempt assets include, *inter alia*, the homestead,[43] qualified retirement plans,[44] cash surrender values of life insurance policies,[45] and annuities.[46]

In urban areas, the homestead of a family or single adult may not exceed one acre. In rural areas, the homestead of a single adult may not exceed 100 acres, but the homestead of a family may

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[41]*See* Gerald A. Marks, *An Overview of Asset Protection, Business Succession and Estate Planning Considerations for Franchisees*, 201-FEB N.J. LAW. 23 (2000).

[42]*Id* at 23.

[43]TEX. PROP. CODE ANN. §41.001 (Vernon 2000).

[44]TEX. PROP. CODE ANN. §42.021 (Vernon 2000).

[45]TEXAS INS. CODE ANN. art. 21.22, §3 (Vernon 2002)(*providing* in relevant part that policy proceeds and cash values to be paid or rendered to the insured or any beneficiary under any annuity contract issued by a life, health, or accident insurance company is fully exempt from execution, attachment, garnishment, or other process, and further, is fully exempt from being seized, taken, appropriated, or applied by any legal or equitable process or operation of law to pay any debt or liability of the insured or of any beneficiary, either before or after said money or benefits is or are paid or rendered).

[46]*Id.*

include up to 200 acres.[47]

In addition to the homestead, an individual's rights under any stock bonus, pension, profit sharing, or similar plan, including retirement plans for the self employed, any annuity purchased using proceeds from a plan described above, and any retirement or annuity account described under IRC §403(b) is exempt from attachment, execution, and seizure for the satisfaction of debts.[48]

Finally, Article 21.22 of the Texas Insurance code provides that benefits from insurance policies, such as policy proceeds and cash values payable to an insured or beneficiary, and benefits under an annuity contract shall be fully exempt from execution, attachment, garnishment, or other process, including any bankruptcy proceeding of the insured or beneficiary.[49]

The protections afforded to exempt assets will be frustrated, however, if a person uses non-exempt property to obtain an interest in, make improvements to, or pay an indebtedness on exempt property with the intent to defraud, delay, or hinder the acquisition of such non-exempt asset by an interested person entitled to such non-exempt property.[50]

B. Isolate Assets to Insulate Them from the Liability Exposure of Other Assets

In addition to boosting investments in exempt assets, the business owner must isolate, to the extent economically efficient, the activities and/or assets of the business. For example, a construction company would probably create at least three different business entities. The land on which the business operates would be owned one business entity, the construction services would be managed under another business entity, and the equipment would be owned by yet another separate business entity. The business entity providing the construction services might then lease the building and equipment from the respective business entities owning such building or equipment.[51]

C. Structuring Business Entities to Make Them less Attractive to Judgment Creditors

Limited partnerships and limited liability companies offer an added layer of asset protection not available to the shareholders of a corporation. A properly run corporation will protect the shareholders from being exposed to personal liability by the judgment creditors of a corporation. However, the stock of the corporation is not protected from the individual liabilities of its shareholders. The creditors of a shareholder may attach the corporate stock of the shareholder; and if the shareholder has a controlling interest in the corporation, the creditor may gain control of the corporation. Even if a creditor is unable to gain control of the corporation, the acquisition of corporate stock by a judgment creditor of a shareholder could pose a meaningful threat to other

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[47]TEX. PROP. CODE ANN. §41.002(a) (Vernon 2000) .

[48]TEX. PROP. CODE ANN. §42.0021 (Vernon 2000).

[49]TEX. INS. CODE ANN. §21.22 (Vernon 2002).

[50]TEX. PROP. CODE ANN. §42.004(a) (Vernon 2002).

[51]Marks, Gerald A., *An Overview of Asset Protection, Business Succession, and Estate Planning Considerations for Franchisees*, NEW JERSEY LAWYER, February 2000, at 23.

shareholders in the corporation, especially in the context of a small business. For example, an S corporation could lose its S corporation tax status if a creditor, who was not a permitted shareholder of an S corporation, were to attach the stock of the S corporation.

The added measure of protection afforded to limited partners of a partnership and members of a limited liability company stem from statutory and non-statutory sources.

1. Statutory Protections Afforded to Limited Partners of Partnership. While the judgment creditors of a shareholder may attach, via judgment, the corporate stock of such shareholder, the partners of a limited partnership and the members of a limited liability company are protected from such attachment, as the only remedy under statute that a judgment creditor may receive against the interest of a partner in a limited partnership or a member of a limited liability company is a charging order against such interest.[52]

Rooted in English law, the charging order developed as a way to prevent the creditor of one partner from holding up the business of the entire partnership and causing injustice to the other partners. To prevent the "clumsy method of proceeding," the English rule forbidding execution sale of a partner's interest in the partnership to satisfy a non-partnership debt was codified in the Uniform Partnership Act and English Partnership Act of 1890. Under the revised English rule, the creditor's remedy against a partner was limited to receiving the partner's share of the partnership's profits and surplus.[53]

When a creditor of a limited partner receives a charging order against such limited partner's

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[52]*See* TEX. REV. CIV. STAT. ANN. art. 6132b, §7.03 (Vernon 1997) ("TEXAS REVISED LIMITED PARTNERSHIP ACT"):

> On application to a court of competent jurisdiction by a judgment creditor of a partner or of any other owner of a partnership interest, the court may charge the partnership interest of the partner or other owner with payment of the unsatisfied amount of the judgment, with interest, may then or later appoint a receiver of the debtor partner's share of the partnership's profits and of any other money payable or that becomes payable to the debtor partner with respect to the partnership, and may make all other orders, directions, and inquiries that the circumstances of the case require. To the extent that the partnership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the partnership interest.

See also TEX. REV. CIV. STAT. ANN. art. 1528n §4.06 (Vernon 1997) ("TEXAS LIMITED LIABILITY COMPANY ACT"):

> On application to a court of competent jurisdiction by a judgment creditor of a member or any other owner of a membership interest, the court may charge the membership interest of the member or other owner with payment of the unsatisfied amount of the judgment. Except as otherwise provided in the regulations to the extent that the membership interest is charged in this manner, the judgment creditor has only the rights of an assignee of the interest. This Section does not deprive any member of the benefit of any exemption laws applicable to that member's membership interest.

[53]*See Taylor v. S & M Lamp Co.*, 190 Cal. App. 2d 700 (1953).

partnership interest, the creditor's interest in the partner's share of the partnership is limited to that of an assignee.[54] While the creditor may enjoy the partnership distributions that would have been distributed to the debtor partner in the absence of such creditor, the creditor does not receive the rights of such partner.

> As an assignee of a partnership interest, the creditor may not become a limited partner unless all other partners consent, something unlikely to occur. The creditor cannot vote on partnership matters, inspect or copy partnership records, or even obtain from the general partner business and tax information regarding the affairs of the limited partnership that are usually available to limited partners as a matter of law. Moreover, in a family limited partnership, the general partner will likely be a family member sympathetic to the plight of the partner who has been subject to the creditor's charging order. Thus, it is unlikely that the general partner would elect to make a cash distribution to partners which would entitle the creditor/assignee to a distribution.[55]

Even though the judgment creditor of a limited partner has no rights with regard to the partnership, other than receiving an income distribution, the IRS has long taken the position that an assignee acquiring substantially all of the dominion and control over the interest of a limited partner is treated as a substituted limited partner for federal income tax purposes.[56] Since the income of a partnership flows through to the partners, the partners are taxed on the income whether or not they actually received it. Further, only the general partner of the partnership may make distributions to the limited partners. As a consequence, well advised creditors of limited partners will not seek satisfaction of judgments through charging a limited partnership interest for fear that they will be required to pay income taxes on partnership income not distributed to them.

The limited liability company offers its members the same level of protection from creditors as the limited partnership, perhaps even more protection because the Texas Limited Liability Company Act fails to list the remedies available to a creditor who obtains a charging order. Conspicuously, the Texas Revised Limited Partnership Act provides the remedy of foreclosure[57] while the Texas Limited Liability Company Act fails to list foreclosure as a remedy to a creditor holding

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[54]VERNON'S ANN. TEXAS CIV. ST. art. 6132b, §§ 25(2)(c), 28 (Vernon 1997).

[55]Mata, Mario A., *Asset Protection Strategies for Business Owners*, presented at the Corporate, Partnership, and Business Law course, offered by the University of Houston Law Foundation (July 2001).

[56]Rev. Rul. 77-137 1977-1 C.B. 178 (*explaining* that even though the general partners did not give their consent to an assignment, since the assignee acquired substantially all of the dominion and control over the limited partnership interest, for federal income tax purposes, the assignee is treated as a substituted limited partner and the assignee must report the distributive share of partnership income attributable to such interest on the assignees federal income tax return).

[57]*See* TEXAS REVISED LIMITED PARTNERSHIP ACT §7.03.

a charging order.[58] Practitioners have been reluctant to replace the limited partnership with the limited liability company as the centerpiece of an estate plan, perhaps because the limited liability company is relatively new in the United States and, as a consequence, does not have a depth of case law supporting its use as an asset protection tool. Also, the fact that the limited liability company is subject to franchise tax in Texas may stymie the growth of its popularity.

The limited liability company has replaced the corporation as the entity of choice for serving as a general partner of a limited partnership. In the past, corporations typically served as the general partner of limited partnerships, as the shareholders of a corporation were protected from the liabilities of the corporation. However, this arrangement failed to protect the limited partners from the creditors of the shareholders of the corporate general partner because the creditors could attach the stock of the corporation and gain control of the partnership. The limited liability company offers the benefit of protecting the members from the liabilities of the company. Moreover, the limited liability company is protected from the judgment creditors of its members in much the same way as a limited partnership. Consequently, because control of the limited liability company cannot be transferred to the judgment creditors of a member, the limited liability company is preferred over the corporation as the entity of choice to serve as general partner of a limited partnership.

2. Non-statutory Protections Afforded to Limited Partners. In light of the limited and disagreeable options available to the creditor seeking to satisfy a judgment by charging a limited partner's interest in a limited partnership, the creditor will likely be more amenable to settlement. Moreover, the partnership should anticipate the possibility of partnership interests being charged by the judgment creditor of a limited partner and draft the partnership agreement to protect the limited partners. Mario A. Mata, an attorney in Austin, Texas, suggests that a well drafted partnership will have protective language granting to the limited partners, who are not affected by the creditor, the option to purchase the creditor's interest in the partnership.[59] In addition, the partnership agreement should "provide for a quick, simplified, and favorable method of valuing the interest of the charged partner."[60]

VI. Planning for the Death of a Business Owner with a Focus on the Family Business

Planning for the death or incapacity of a business owner is often overlooked, despite its importance to the continued success of the business. According to Bill Van Pelt, senior vice president of The Mid-Continent Companies, Ltd., Houston, Texas, "[t]he greatest threats to the continuing family ownership of privately held companies are usually bad family dynamics and taxes."[61] The statistics show that these threats stymie the success and continuity of most family businesses, as 30 percent of family businesses are continued by the second generation and only 12 percent survive until

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[58]*See* TEX. LIMITED LIABILITY COMPANY ACT §4.06.

[59]*See* Mata, *supra* note 55.

[60]*Id.*

[61]Bill Van Pelt, IV, *Saving a Family Business for Future Generations*, TRUST & ESTATES, December 2002, at 41.

the third generation.[62] Well advised business owners diminish the potency of these threats by: 1) recognizing the difference between equity interests and controlling interests; 2) understanding that the goals of future equity interest holders may be incongruent with the goals of the business; and 3) structuring gifts or bequests of such interests to minimize estate, gift, and income taxes.

A. Issues Involved in the Death of a Business Owner

Most business owners must balance two often competing goals: 1) survival of the small business; and 2) equality in the treatment of family members. The competition between these goals is intensified if estate tax is anticipated to be an issue and if the small business represents a large portion of the business owner's estate. Given the fact that family members will have differing levels of personal interest in the family business, the business owner should understand that equality among family members does not necessarily mean equality of control and equality of equity. Rather, it is often necessary to separate equity from control in a family business in order to harmonize the goals of maintaining a successful business and maximizing equality among family members.

1. Succession of Ownership and Control. A succession strategy which focuses too heavily on equality among family members will often fail to survive for future generations because the ownership and control of the family business will become too diffuse to compete in a nimble marketplace.[63] A successful succession plan for the business owner will: 1) provide for centralized control by family members active in the family business; 2) grant to other, non-participatory members of the family an equity interest in the business; 3) provide for the valuation of a family member's business interest in the event the family member seeks to liquidate his or her interest; and 4) minimize income and transfer taxes.

2. Valuation of Business Interests and Deductions Available to Estates of Business Owners. Naturally, the interests of a family member, or any investor for that matter, seeking to divest himself from the business will conflict with the goals of the business. To reduce this conflict, a mechanism for calculating the divesting stakeholder's interest must be developed by the business owner and set out in the governing instruments of the business.

a. Appraisal Methods. Accepted methodologies for the determination of value of business interests include: 1) pre-determined price; 2) book value; 3) liquidation value; 4) and market value.[64] Most investors prefer using market value of a business interest as the value for which

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[62]*See* Goldstein, *supra* note 1.

[63]*See* Van Pelt, *supra* note 61. "Succession strategies, usually seeking to reduce estate taxes, tend to be strongly influenced by a strong desire to treat all children and grandchildren similarly. One result is that equity ownership of the family business often gets diffused."

[64]T. Deon Warner, *Shareholder Agreements* (July 2001)(unpublished manuscript, on file with the University of Houston Law Foundation).

a transfer may take place, as it most accurately reflects the value of the business interest.[65]

In Revenue Ruling 59-60, the IRS sets the groundwork for the valuation of small business interests. While the language of this ruling applies only to valuations of closely held corporations for tax purposes, the analysis used by the IRS may be applied to other small business interests and is useful as a framework to value business interests for purposes other than tax matters. Specifically, the factors the IRS considers include: 1) the nature of the business and history of the enterprise; 2) economic outlook in general and the condition and outlook of the specific industry in which the business is engaged; 3) book value of stock and financial condition of the business; 4) earning capacity of business; 5) dividend paying capacity of business; 6) whether or not the business has goodwill or other intangible value; 7) past sales of stock and the size of the block subject to valuation; and 8) the market prices of stock of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market.[66]

The considerations outlined by Revenue Ruling 59-60 may create a framework for the valuation of a business interest, but the methodology used by the Revenue Ruling was not designed to define the range of possible outcomes nor did it contemplate lack of marketability discounts, lack of control discounts, or premiums for control. Consequently, when designing a framework for valuation of business interests upon transfer, the well advised business owner should define what factors will be considered in an appraisal of business interests.

b. Special Use Valuation. The executor of a business owner's estate may elect under Section 2032A of the Code to value qualified farm or other real property owned by a closely held business based on the *actual use* of the property instead of based on its fair market value, which considers its *best and highest use*. In order for an estate to qualify to elect special use valuation, two tests must be satisfied. First, at least 25 percent of the adjusted gross estate must contain real property which: 1) passed from the decedent to a qualified heir; 2) was used by the decedent or the decedent's family as a farm or business for at least five years during the eight years preceding the decedent's death; and 3) the decedent or the decedent's family materially participated in the operation of the farm or business for at lease five years during the eight years preceding the decedent's death.[67] Second, at least fifty percent of the adjusted gross estate must consist of real and/or personal property of the decedent being used by the decedent or his family as a farm or in a closely held business and such property must have passed to a qualified heir.[68] While the IRS factors the value of the personal property into the second test, no special use valuation is available to the personal property.

c. Alternate Valuation. Section 2032 of the Code enables the executor of an estate to value the assets remaining in the estate of the decedent as of six months after the date of the decedent's death, as opposed to the date of the decedent's death. If an alternate valuation date is used, assets which were disposed of or distributed during the six month period after the decedent's

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[65]*Id* at 15.

[66]Rev. Rul 59-60, 1959-1 C.B. 41.

[67]I.R.C. § 2032A(b)(1).

[68]*Id.*

death will be valued as of the date such assets were disposed of or distributed. Electing an alternate valuation may allow an estate to pay less estate tax if the assets in the estate declined in value after the decedent's death.

The alternate valuation may only be used if it decreases the value of the gross estate and if it results in less estate or generation skipping transfer tax being due.[69] Consequently, it may not be used to increase the value of a non-taxable estate in an effort to increase basis. Further, the alternate valuation may not be used to decrease the value of assets where the decline in an asset's value is due to the mere passage of time.[70]

d. Qualified Family Owned Business Deduction. The qualified family owned business deduction allows a deduction from the gross estate of a decedent for the adjusted value of the decedent's interest in a qualified family-owned business.[71] The deduction is limited to $675,000; and if the full deduction is used, the exemption equivalent available to the decedent's estate cannot exceed $625,000.

To qualify for the family owned business deduction the following conditions must be met. First, the decedent must have: 1) carried on a business or trade as a proprietor; 2) the decedent and his family must have owned at least a 50% interest in a business entity carrying on a trade or business; 3) the decedent and his family must have owned an interest in a business in which at least a 70% interest in the business was owned by the decedent and his family along with one other family; or 4) the decedent and his family must have owned an interest in a business in which at least a 90% interest in the business was owned by the decedent and his family along with two other families.[72] Second, the value of the business interests included in the decedent's estate plus the value of gifts of business interests made during the lifetime of the decedent and included in the gross value of the decedent's estate must total more than 50% of the decedent's adjusted gross estate.[73] Third, the decedent's business interest must pass to qualified heirs. Qualified heirs include the decedent's spouse, children, spouses of children, parents, siblings, and anyone actively employed in the business for at least ten years prior to the decedent's death. Additionally, during a ten year period after the decedent's death, a qualified heir or a member of the qualified heir's family must operate the business for at least three years during an eight year period, otherwise the estate taxes avoided using the qualified family owned business deduction must be paid back with interest.

The use of the qualified family owned business deduction has waned in recent years due to the popularity of the family limited partnership and the increase in the exemption equivalent. The qualified family owned business deduction will not be available to estates of decedents dying after December 31, 2003.

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[69]I.R.C. § 2032(c).

[70]I.R.C. § 2032(a)(3).

[71]I.R.C. § 2057.

[72]I.R.C. § 2057(e)(1).

[73]I.R.C. § 2057(b)(1)(C)(ii).

e. Payment of Estate Tax in Installments. If a closely held business interest constitutes at least 35% of the value of a decedent's adjusted gross estate, the executor of the decedent's estate may elect to pay estate tax in installments over an extended period of time.[74] The portion of estate tax that may be paid in installments over an extended period of time is equal to the proportion in which the value of the closely held business interest bears to the value of the adjusted gross estate.[75] Additionally, if an estate qualifies under the rules set out in Section 6166, it may pay interest only for the first four years after the date the tax is due and begin making installment payments of principal and interest after that for up to ten years.

B. Tools Available to Aid Business Owners in Succession Planning

1. Limited Partnerships. The widespread use of limited partnerships in succession planning can be attributed to the following estate planning benefits with which the limited partnership has been associated: 1) valuation discounts for estate and gift tax purposes; 2) gifting of equity interests without transferring control; and 3) protection from creditors. Further, with the advent of the check the box regulations[76] and the amendments to the Texas Business Corporation Act, which provide for the conversion of a Texas corporation into another entity without a merger or transfer of assets,[77] many small Texas business corporations have converted into limited partnerships to avoid the Texas franchise tax.

a. Valuation Discounts for Estate and Gift Tax Purposes. Generally, the valuation discounts for estate and gift tax purposes available to limited partners of a limited partnership are deeper than the valuation discounts associated with closely held stock, or membership interests in a limited liability company. Tax courts have recognized the discounts associated with limited partnership interests in numerous cases.[78] Limited partnership interests are discounted based on their lack of marketability, lack of control, and illiquidity.[79] While the tax courts have generally upheld the valuation discounts on limited partnership interests, these discounts may be frustrated if, *inter alia*, a limited partner has the power to dissolve the partnership or if gifts of limited partnership interests are made before the limited partnership is funded.

The availability of deeper discounts in value on limited partnership interests exists because the rights of limited partners are similar to the rights of an assignee under the Texas Revised Limited

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[74]I.R.C. § 6166(a)(1).

[75]I.R.C. § 6166(a)(2).

[76]Treas. Reg. §301.7701-03.

[77]*See* TEX. BUS. CORP. ACT ANN. arts. 5.17-5.20.

[78]*See Estate of Dailey*, T.C. Memo. 2001-263 (*allowing* a 40% discount); *Estate of Stevens*, T.C. Memo. 2000-53 (*supporting* a 25% discount); *Estate of Jones*, 116 T.C. 121 (2001)(upholding a 48% discount).

[79]*See id.*

Partnership Act (TRLPA).[80] However, if a limited partner is also a general partner, such discounts may be limited. This follows because Section 6.02 of the TRLPA provides that a general partner may withdraw at any time and such withdrawal will result in dissolution of the partnership unless another general partner remains and the partnership agreement allows the partnership to continue, or within 90 days of the withdrawal, the remaining partners appoint a successor general partner.[81] The general partner's right to withdraw may frustrate claims of discounts on the limited partnership interests held by the general partner.[82] Consequently, if a business owner's goal is to compress the value of the business for estate and gift tax purposes, some practitioners believe it is critical that such owner is not a sole general partner of the partnership, nor a controlling member or shareholder of an LLC or corporation that serves as the general partner of the partnership, lest the value of such partner's limited partnership interest fail to receive a significant discount.[83] Other practitioners assert that, if the partnership agreement provides that a general partner's interest converts to a limited partnership interest upon the death of such general partner and such converted interest is deemed an assignee interest, the valuation of such general partner's assignee interest will not receive as deep a discount as the valuation of such partner's limited partnership interest, but such general partnership interest will not greatly limit the valuation discount of such general partner's limited partnership interest.

Another important pitfall for the unwary involves the timing of transfers to the partnership and gifts of units of limited partnership interests. The Tax Court in *Shepherd v. Commissioner* accepted the IRS' position that if a taxpayer contributed property to a family limited partnership in which interests in the limited partnership were already gifted before contributions of assets were made to such partnership, that the taxpayer should be deemed to have made a gift of the difference between what the taxpayer contributed to the limited partnership and what the taxpayer received back from the limited partnership in the form of limited or general partnership interests.[84] In the instant case, the Tax Court focused on what the taxpayer gave, and not what the beneficiary received, signaling a move toward the rule applied in England where gifts are valued to the extent they reduce the net worth of the grantor.[85]

In the 1990's, the estate and gift tax regime posed a grave threat to the family business, as the maximum estate tax rate was 55% (60% for estate valued at more than $10,000,000). The planned increase in the unified credit will make discounts less attractive to small businesses, especially if the value of a business makes estate tax planning irrelevant. If planning for estate tax is unnecessary,

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[80]*See* TEXAS REVISED LIMITED PARTNERSHIP ACT §7.03.

[81]*See* TEXAS REVISED LIMITED PARTNERSHIP ACT §8.01.

[82]*See* Thomas W. Houghton, *Family Limited Partnerships: Uses, Limits, and Ethical Considerations* (July 2001)(unpublished manuscript, on file with the University of Houston Law Foundation)

[83]*Id.*

[84]*See Shepherd v. Commissioner*, 115 T.C. 30 (2000).

[85]*See* James L. Dam, *U.S. Tax Court Restricts Family Limited Partnership Discounts,* LAW. WKLY., November 27, 2000.

receiving a discount on a decedent's interest in a family business might actually cause more tax to be due in the long run because the decedent's family might have been better off claiming a higher value and, as a consequence, receiving a higher step up in basis.

b. Gifting Equity Interests Without Sacrificing Control. Another important advantage of the limited partnership for estate planning purposes involves the ability of a business owner to transfer equity interests in the business without transferring control. Limited partnerships provide a mechanism for separating equity interests from control interests. The separation of equity interests and control interests is especially important in two situations.

First, when a business owner seeks to transfer wealth down to children or grandchildren but does not want those individuals involved in making business decisions, he can make gifts of limited partnership interests to them, transferring value but not control. Second, when a business owner desires to transfer equal amounts of equity to children or grandchildren but also wants control of the business to remain centralized in family members who are active participants in the business, the business owner may transfer interests in the entity acting as general partner to the actively participating family members while transferring limited partnership interests to other family members.

2. Stakeholder Agreements. All comprehensive partnership agreements, operating agreements, and shareholder agreements contain provisions for the succession of business interests. For the purposes of discussing succession planning, these three agreements will be referred to together as "stakeholder agreements." In his article "What Every Business Lawyer and Business Owner Should Know About Buy-Sell Agreements," Fredric D. Tannenbaum explains: "[l]ike the foundation of a very expensive house, the agreement is frequently overlooked and unappreciated. However, it can provide the cornerstone of a successful business enterprise and personal relations and serve as a bedrock during turbulent times."[86] A well drafted stakeholder agreement will provide the following: 1) predictability and continuity of ownership; 2) orderly transfer of ownership; 3) a market for the ownership interests; 4) a fair price for the interests being negotiated; 5) protection for minority interest holders; 6) protection for majority owners; and 7) minimization of income and transfer taxes.[87]

The transfer of ownership methodology outlined by stakeholder agreements often take three forms: 1) a redemption; 2) a cross purchase; or 3) a hybrid between the redemption and cross purchase.

The redemption of interests by the business, which involves a buy-out provision where the business entity either agrees to purchase the interest or is offered a right of first refusal upon the occurrence of a specific event, is straightforward and easy because only two parties are involved, the business and the departing interest holder. Unfortunately, in the corporate context, the redemption of interests by the business entity has potential disadvantages. First, the remaining shareholders of the business do not receive a step up in basis for the interest redeemed by the business. Second, if

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[86]Fredric D. Tannenbaum, *What Every Business Lawyer and Business Owner Should Know About Buy-Sell Agreements*, 45 No. 7 PRAC. LAW. 55, 56 (1999).

[87]*Id* at 58.

the redemption is funded with appreciated property, then the business may recognize a gain or loss.[88] Third, if the redemption transaction triggers capital gain and not dividend treatment, then the earnings and profits will be proportionately reduced; and if the redemption transaction triggers dividend treatment, the earnings and profits are reduced by the full amount of the redemption.[89] As a consequence, the departing shareholder would prefer capital gain treatment and the remaining shareholders would prefer dividend treatment.[90] Fourth, if a family member sells all or a large part of his business interest yet participates in the family business after such sale, the sale could trigger dividend treatment to the selling shareholder.[91] Fifth, the purchase of interests by the business could deplete the working capital of the business.

While the cross purchase agreement, which requires remaining shareholders to purchase the shares of the exiting shareholder, may involve more parties, require multiple life insurance policies, and be more difficult to enforce, it has numerous benefits. First, the remaining shareholders receive a step up in basis when they purchase shares from a departed shareholder. Second, a family member selling all or substantially all of his interest to the family business would receive capital gain treatment on the sale, even if the divesting family member continued to participate in the family business. Third, the earnings and profits of the business are reduced by the full amount of the purchase.

Often the timing of the event that triggers the use of a stakeholder agreement cannot be anticipated or planned, especially when the event involves the death of a shareholder. Consequently, well advised business owners will seek maximum flexibility in the construction of the buy-sell provisions of the stakeholder agreement. To increase flexibility, a "wait and see" or hybrid approach to the transfer of ownership may be used. The "wait and see" or hybrid approach allows the business to have the first option to purchase a departing shareholder's interest. In the event the business fails to fully exercise such option, the option passes to the remaining shareholders.[92]

Other common transfer restrictions include: 1) push pull; 2) absolute prohibition; 3) permitted transfers; and 4) tag-along transfers. A push pull provision allows stakeholder #1 to offer to purchase stakeholder #2's interest and if stakeholder #2 refuses to sell such interest, stakeholder #2 must purchase stakeholder #1's interest upon the terms set out in stakeholder #1's original offer. While the push pull approach might result in an accurate valuation of a stakeholder's interest, it is useful only in limited circumstances. The push pull provisions are best suited for use between two persons of similar bargaining power and available resources.

Transfer restrictions common in limited partnership agreements include the absolute prohibition and the permitted transfer. Under an absolute prohibition, the business entity and all other stakeholders must agree to the transfer. Permitted transfers allow for transfers of interests to a permitted class, usually family members or trusts for the benefit of family members. Finally, tag along provisions require minority stakeholders to join in sales approved by the majority stakeholders.

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[88]IRC §311(b).

[89]IRC §312(n)(7).

[90]*See* Tannenbaum, *supra* note 86, at 61.

[91]Rev. Rul. 58-614, 1958-2 C.B. 193 (1958).

[92]*See* Tannenbaum, *supra* note 86, at 62.

3. Trusts. To avoid the diffusion of interests to numerous family members upon the death of a business owner, which more often than not leads to the demise of a family business, many practitioners recommend the use of trusts. Like the limited partnership, trusts enable the grantor to separate equity from control and allow business decisions to be made by those family members who are active participants in the family business, creating the framework for strong and decisive management of the family business. In addition, the trust, if properly drafted, may create greater tax efficiency in the event a family member desires divestiture.

a. Separation of Equity and Control. As a family business passes from one generation to the next, the resulting increase in the number of people involved in the business frequently creates tension, confusion, and indecisiveness. In his article, "Saving a Family Business for Future Generations," Bill Van Pelt, IV explains that "there can be profound differences in the perspectives and objectives of those family shareholders who are active in the business and those who are not. Often these differences lead the inactive shareholders to seek a liquidity event."[93] Such liquidity events can weaken the family business by reducing its capital base and threaten the continued viability of the business. It follows that the value of the non-divesting member's interests in the family business would then be reduced.

Making lifetime gifts of business interests to a single trust for the benefit of the descendants of the business owner may alleviate some of the problems associated with the increase in the number of stakeholders.[94] The trust should be carefully drafted to define how members of management are to be selected. The trust should also address who will make the decision to sell or retain interests in the business. Additionally, "provisions of the trust agreement can be crafted to solicit the involvement of each stakeholder, while allowing for their degree of input to change to compliment the family's strengths and weaknesses and to balance competing interests within the family."[95] Examples of decision making structures written into a trust might include the following: 1) majority vote by children; 2) majority vote by children and grandchildren with each child receiving one vote and the grandchildren voting collectively; 3) majority vote by descendants who have been active in the business for X years; or 4) majority vote by three groups with one group consisting of adult trust beneficiaries, another group consisting of the business' executives, and another group of outside advisors selected by the business owner.[96]

b. Tax Efficiency. If properly drafted, a trust can create greater tax efficiency in the event one or more family members seek divestiture. For example, if a trust owns assets or has liquidity outside of the family business, the trust can reshuffle assets to provide non-business assets to divesting family members without triggering income tax to the divesting family member.[97]

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[93] *See* Van Pelt, *supra* note 61, at 41.

[94] *See id* at 44.

[95] *Id* at 45.

[96] *Id* at 45.

[97] *See id* at 46.

VII. Conclusion

The introduction of the check the box regulations by the IRS coupled with the amendments to the Texas Business Corporation Act, allowing a corporation to convert into another business entity, expanded the choice of entity options available to business owners and increased the importance of analyzing non-tax related choice of entity issues. The expanded spectrum of choices available to the business owner seeking to choose a form in which to do business necessitates a professional willing and able to explore the options with his client. Such analysis must consider the asset protection needs of the client, the management desires of the client, the transfer of business interests upon the death or incapacity of the client, and the income tax issues involved in choosing a business entity.

APPENDIX A

February 26, 2003

Client Number One
Address
City, State Zip

Client Number Two
Address
City, State Zip

Re: Consent to Multiple Representation in Planning and Forming Business Entity and Acting as Its General Counsel

Dear Client Number One and Client Number Two:

Thank you for the confidence that you have expressed in me and in my firm in seeking our representation of you in the planning and formation of your business. As I explained to you in our meeting, representing both of you in this common matter presents the potential for a conflict of interest. I suggested at our meeting that you should consider seeking independent representation. Nevertheless, it was your common desire that I represent you both. In order to represent both of you in this matter, you must be aware of the potential problems that could arise from such common representation and give your informed consent to such common representation. Additionally, if your interests become adverse to one another, I must withdraw my representation of both of you. My representation of you is governed by the Texas Disciplinary Rules of Professional Conduct, as adopted by the Supreme Court of Texas and the State Bar of Texas. Below I have outlined some issues unique to multiparty representation that you should understand:

1. **Attorney-Client Privilege.** Each of you must waive the attorney-client privilege to the extent such privilege would prevent disclosure of information to your fellow business associates who are also being represented by me or my firm.

2. **Withdrawal of Representation.** Each of your interests appear to be aligned with regard to the major issues involved in the planning and formation of the business organization. However, if at any time, it becomes apparent that your interests are in conflict with regard to major issues involved in the planning and formation of the business organization, or if there is disagreement among you relating to, including but not limited to the: organization or capitalization of the business organization, tax status of the business organization, amount or

type of stock, terms of organizational documents, terms of loans or leases, my firm and I must withdraw from representing both of you.

3. **Prior Representation of Client Number One.** As each of you know, I have represented Client Number One on a previous legal matter. I do not believe this prior representation will cause me to be biased in favor of Client Number One, nor do I believe it will adversely affect the representation of you both in this current legal matter. If at any time I believe that my previous representation of Client Number One has created a bias in favor or against Client Number One in my representation of you both, I must withdraw my representation of you both.

Again, my firm and I appreciate the confidence that you have expressed by seeking our counsel. If you agree with and understand the issues presented in this letter, please sign where indicated to memorialize your agreement and understanding. If you have any questions or concerns regarding the issues presented in this letter, please do not hesitate to call me.

Very truly yours,
RIDDLE & BRAZIL, LLP

Tamorah Christine Butts

I have read this letter and I understand the issues presented herein. Despite the fact that I have been advised that I should seek counsel independently from my business associates, I, nevertheless, wish to be represented by this firm along with the business associates listed as addressees in this letter in the planning and organization of our common business enterprise.

_____
Client Number One

_____
Client Number Two

APPENDIX B

Choice of Business Entity

	SOLE PROPRIETORSHIP/ GENERAL PARTNERSHIP	CORPORATION	LLC	LIMITED PARTNERSHIP
Formation	Formed when one or more individuals go into business together.	Formed by filing Articles of Incorporation with Secretary of State	Formed by filing Articles of Organization with Secretary of State	Formed by filing Certificate of Limited Partnership with Secretary of State
Liability Protection	None Note: General Partnership can elect to be a limited liability partnership by filing a statement with the Secretary of State.	Yes. Shareholder's liability is limited to shareholder's interest in entity if corporate veil is not pierced. However, no business asset protection is available	Yes. Member's liability is limited to member's interest in entity if entity's veil is not pierced. Also, business asset protection is available.	Yes. Limited Partner's liability is limited to such Partner's interest in entity. However, General Partner has unlimited liability. Business asset protection is available.
Formalities	None needed as entity is alter ego of business owners.	Corporate formalities need to be observed in order for corporate structure to be respected by courts.	Members must adhere to formalities of operating LLC to keep veil intact.	Structure of entity must be respected by partners.
Taxation (Federal and State)	Simple because it is pass through taxation. Also, not subject to franchise tax.	C Corp: Subject to double taxation. S Corp: Pass through taxation. It is subject to franchise tax.	Tax schemes possible: Sole Proprietorship, Partnership, C Corp, and S Corp. LLC is subject to franchise tax.	Pass through taxation. LP is not subject to franchise tax.
Common Uses (Business that benefit from being structured as this type of entity)	Small businesses where business owns assets of little value and owners perform activities of business. Not appropriate for moderate to wealthy business owners.	Business owners seeking venture capital, going public, growth, increase value of business, or requiring a large capital base. Small businesses are usually S Corporations	Any type of business, small to large, seeking limited liability protection in a simple entity, and desiring to protect business assets from shareholder liabilities.	Businesses seeking to avoid franchise tax and highly leveraged businesses. Families also use family limited partnerships for estate planning and asset protection purposes.

APPENDIX B

Choice of Business Entity

Other types of entities available	Registered Limited Liability Partnership	Professional Corporation, Professional Association, and Nonprofit Corporation.	Professional Limited Liability Company	None