Generally speaking, there are three basic types of legal entities in which business can be conducted: (1) sole proprietorship, (2) partnership, and (3) corporation. Within each category, there are several variations. Determining which form is best for a particular commercial enterprise depends on a variety of considerations, including the number of owners, acceptable liability of owners, tax treatment, transferability of ownership interests, set-up costs, and other factors.

Sole Proprietorship. This is a form of business involving one and only one owner. No special legal documents are needed to establish a sole proprietorship and really it is not even a distinct legal entity, separate from its owner. As a result, the owner is liable for all of the debts and liabilities of the business, but has total control of the business. If the business is to be conducted under a name, it is necessary to file an assumed name certificate (sometimes referred to as a "dba") in any county in which the business is to be conducted. The business does not file a separate tax return, although the owner must prepare a Schedule C to be included in his or her individual tax return. While the assets of a sole proprietorship (including its name) can be sold, it is not possible to transfer a sole proprietorship to someone else.

Partnership. A partnerships is a form of business entity involving two or more owners. A partnership is <u>not</u> taxed as a separate entity (though it does file an "informational" tax return) and all profits and losses "flow through" from the partnership to the individual partners and must be included in the individual owners' returns. There are several types of partnerships: general partnership, limited partnership (Ltd.), joint venture, and limited liability partnership (L.L.P.) are the most common. A *general partnership* is,

in many respects, similar to a sole proprietorship except that it involves more than one owner. All partners are liable for the debts and liabilities of the partnership and, ordinarily, all partners are able to bind the partnership. Unless they agree otherwise, all partners have equal management rights. Generally speaking, changing partners, or the death of a partner, dissolves a general partnership, so general partnership interests are not readily transferrable (though there are ways to minimize the disruptive effects of this aspect of a general partnership). A joint venture is a special kind of general partnership formed to pursue a single business project (for example, development of an apartment project) and once that undertake is finished, the venture is dissolved.

A *limited partnership* is a partnership composed of one or more general partners and one or more limited partners. The general partners have unlimited liability for the debts and liabilities of the partnership, but so long as they remain passive investors and do not participate actively in the operations of the business, limited partners are liable for the partnership's debts only to the extent of their investment. Limited partnership interests can be transferred and general partners can be replaced, provided the partnership documents so allow, so there is greater transferability of interest in a limited partnership.

A limited liability partnership is a form of partnership typically employed by professionals (such as lawyers or accountants). In this form of partnership, the partners have unlimited liability for their own acts, but not for the debts of the partnership nor for the liabilities of the other partners (except to the extent of their interest in the partnership). Limited liability partnerships can have provisions for the

withdrawal of partners or the admission of new partners without affecting the existence of the partnership.

Limited liability partnerships and limited partnerships require filing of forms with the state to create. It is strongly recommended that a lawyer draft a Partnership Agreement for the partnership, regardless of which kind of partnership is chosen, since the parties need to agree *in advance* on may things, such as management responsibilities and rights, distribution of profits, responsibility for providing additional money to the business (if needed), what should happen upon the death or withdrawal of a partner, and a number of other issues.

Corporation. A corporation is a separate legal entity owned by its shareholders, managed by a board of directors, and operated by its officers. Establishment of a corporation requires preparation and filing of Articles of Incorporation and submission of information to various government offices. If legal formalities are followed, the owners are not liable for the debts or liabilities of the corporation. Further, shares of stock of a corporation may be freely transferred (bought and sold) (subject to applicable state or federal securities laws and regulations). Unlike partnerships and sole proprietorships, corporations are subject to Texas franchise taxes. There are several different kinds of corporations, including C Corporations, S Corporations, Close Corporations, Professional Corporations (P.C.), Professional Associations (P.A.), and Limited Liability Companies (L.L.C.).

A *C corporation* is taxed separately from its owners. This can lead to "double taxation" because the profits are taxed first to the

corporation and then, if they are distributed to the shareholders (as dividends), taxed again. An S corporation is, essentially, a corporation taxed as if it were a partnership. That is, the profits and losses flow through to its owners rather than being separately taxed in the corporation. There are limitations as to the number and kinds of owners an S Corporation may have. A close corporation is a type of corporation designed for smaller companies, owned by a relatively few number of shareholders. In a closed corporation, the shareholders manage the corporation without a board of directors or officers, simplifying legal requirements. Professional corporations and professional associations are corporations established for professionals (such as doctors or lawyers) to take advantage of certain tax opportunities available to corporations, without creating limited liability for professional misconduct (prohibited by state law for such individuals). A *limited liability company* is really not a corporation at all, but a special entity which provides limited liability to its owners, free transferability of interests, but tax attributes of a partnership (that is, pass through of taxability of profits and losses to the owners and no taxation of distributions (dividends)).

There are a number of other types of business entities (such as foundations, associations, trusts, and non-profit corporations) but the forms above listed are the most common ones for most new and start-up businesses.

At the outset, it is a good idea to discuss the best form of business entity with an experienced attorney and an accountant so that the advantages and disadvantages of all forms can be explored, explained, and discussed and the business can be set up properly and optimally from the start.

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