



Riddle & Butts, LLP

Business Entities & Succession Planning



A NOTE FROM THE TEAM



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.

When making the choice of business entity, it is important to consider and balance the following goals: 1) liability protection; 2) maintenance of control over the operation and assets of the business; 3) minimization of income and other related taxes; and 4) maximization of valuation discounts for transfer tax purposes.

Additionally, planning for the death or incapacity of the business owner is critical to the growth, value, and longevity of the business.

About the Team

Michael C. Riddle began his practice of law as a gift and estate tax attorney for the Internal Revenue Service. He graduated from the University of Houston Law School in 1972 and in 1991 became Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate. He is the Managing Partner of Riddle & Butts, LLP and has been practicing law in Harris County and surrounding counties for over 40 years.

Christine Butts is a 1993 graduate of the University of Texas at Austin where she obtained her BBA in International Business. In 1996, she graduated from the University of Houston Law School. Christine is Board Certified in Probate and Estate Planning by the Texas Board of Legal Specialization.

Christine served Harris County as Judge of Probate Court 4 from 2011 to 2018.

Kristi Gourley is a 1997 graduate of Texas A&M University where she obtained her BS in Biomedical Science. In 2003, she graduated from the Paul M. Hebert Law Center at LSU, where she was an editor for the Louisiana Law Review.

Kathryn Hansen is a 2015 graduate of the Texas Tech University School of Law and 2012 graduate of the University of Texas at San Antonio. In addition to being a licensed attorney, Kathryn is a Certified Public Accountant. Prior to joining Riddle & Butts in 2021, Kathryn worked in the tax department of a mid-market accounting firm in Houston where she specialized in tax planning and tax return preparation for individuals and business entities.

Kaitlyn Ready graduated from Texas A&M University in 2016 with a degree in business management. She continued her education at South Texas College of Law. Kaitlyn now handles both probate and estate planning matters.



WHICH BUSINESS ENTITY IS MOST SUITABLE?

Choice of Business Entities

Generally speaking, there are four options to choose from when selecting a business entity in Texas:

- Sole Proprietorship / General Partnership;
- Corporation;
- Limited Liability Company; and
- Limited Partnership.

There are other business entities, of course, such as professional corporations, non-profits, and limited liability partnerships, but those listed above are the most common for-profit entities.

Explore the Non-tax Related Choice of Entity Issues

When forming a business structure, it is important to assess the non-tax related issues separately from the analysis of the tax-related issues.

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 personal assets from the liabilities of his business. Almost every business owner, excluding the sole proprietor, 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.
2. **Transferability of Interests.** While most entrepreneurs are familiar with the veil of protection offered by the corporate form, lesser-known issues involving the transferability

of a business interest may be just as important. In addition to shareholder agreements, partnership agreements, and limited liability company agreements, state and federal laws govern the transferability of business interests. The choice of business entity impacts the transferability 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 must consider the state and federal laws governing the transferability of business interests as those laws relate to each business entity.

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; 2) whether control of the business will be centralized or diffused; and 3) how control of the business is transferred.



OVERVIEW OF FORMS OF BUSINESS ENTITIES

Sole Proprietorship/General Partnership

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. This form of business entity, however, does not offer liability protection to the business owners. When it comes to formalities, this form does not require observation of formalities as the partnership is the alter ego of the business owner.

Sole proprietorships and general partnerships offer a very simple form of taxation. This is because sole proprietorships are considered disregarded entities and general partnerships offer flow through taxation of profits and losses straight to the owners of the business. Additionally, neither of the two are subject to franchise tax in the State of Texas.

Typically, businesses that utilize these forms possess assets of little value and the business owners perform the business activities or they hire independent contractors to do them. It is recommended that, when a small business accumulates assets or takes on employees, it should consider doing business as a statutorily created business entity in order to limit liability.

"Opportunities don't happen.

You create them."

—Chris Grosser

Corporation

A corporation can only be created by filing articles of incorporation with the Texas Secretary of State and the operation of a corporation is governed by the Texas Business Organizations Code. A corporation provides limited liability for its shareholders such that liability is limited to their interest in the corporation. Consequently, when a judgment is recovered by a creditor, it is limited only to the assets and liabilities of the corporation and not those of the shareholders. Exceptions to this include:

1. **No Business Asset Protection.** This is an often ignored drawback of the corporate form. Business asset protection is the protection of business assets from the individual liabilities of the business owners. For example, a judgment creditor of a shareholder could attack the shares of a shareholder, resulting in the loss of shares to the creditor. This could even lead to the creditor becoming the majority shareholder and ultimately running the corporation and selling its assets in order to satisfy the judgement.
2. **Piercing the Corporate Veil.** This refers to an action where the courts disregard the doctrine of limited liability and hold a shareholder responsible for the actions of the corporation. To prevent this, the shareholders must observe corporate formalities. Corporations should keep a minute book including the minutes of meetings, maintain financial records separate from the shareholders, issue stock certificates, adhere to bylaws, maintain the stock ledger, hold directors meetings to approve expenditures, ensure that the corporation is adequately capitalized and insured, and avoid transactions involving self-dealing.

A farm like any other small business must take necessary steps to be recognized as an entity and plan for succession.



When some think of business they imagine big buildings downtown and suits. However, from the board room to your garage these same principles apply.



OVERVIEW OF FORMS OF BUSINESS ENTITIES

Limited Liability Company (LLC)

The limited liability company (LLC) is formed by filing articles of organization with the Texas Secretary of State and it is governed by the Texas Business Organizations Code. 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 members and the courts.

The most significant difference between a limited liability company and a corporation relates to business asset protection. In the event a judgment creditor seeks to satisfy a judgment with a member's interest in a limited liability company, the creditor will obtain only the rights of an assignee, or a right to distributions out of income only, withholding voting rights from the creditor. Therefore, the company and its assets are protected from the judgment creditors of its members.

Just like with a corporation, the courts may pierce the corporate veil and hold individual shareholders responsible for the actions of the limited liability company as a whole. Also like a corporation, a limited liability company must adhere to formalities in order to be respected by the courts, thereby shielding individuals from liability. Generally, the same rules regarding formality apply to both corporations and LLCs.

Limited Partnership (LP)

An LP is created by filing a certificate of formation with the Texas Secretary of State. The LP provides limited liability protection, such that each limited partner's liability is limited to their interest in the partnership. However, the general partner of an LP is personally liable for the liabilities of the LP. As a result, it is recommended that such a business owner form another business entity (such as a limited liability company) to serve as the general partner of the LP, shielding the business owner from personal liability. When selecting a business entity to be used as the general partner of an LP, 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.

The general partner typically has sole control of the management of the LP. Also, like the LLC, the assets of an LP are protected from the judgment creditors of the limited partners. The judgment creditor who satisfies a judgment with a partner's interest in an LP is treated as having the same rights as an assignee, or an interest in the income of the LP that would otherwise be distributed to the indebted partner.

As with any other type of entity, the structure of the LP must be respected by its partners. If respected, then the personal assets of the limited partners are protected from a judgment creditor of the LP. To ensure this protection, adherence to formalities is required.



FIDUCIARY DUTIES

Fiduciary Duties Defined

A fiduciary duty is the legal responsibility to act solely in the best interest of another person or entity, and Texas law places very strict obligations on those with such a duty. While certain designated relationships give rise to a formal fiduciary duty, courts have also recognized that fiduciary duties can arise as a result of informal relationships of trust and confidence in certain business contexts.

In each type of entity, the governing documents may alter (to some extent) the duties and liabilities of controlling or governing persons. Deliberate care and legal advice is therefore necessary for the proper drafting of all relevant governing documents.

Corporations

Generally, officers and directors of a corporation will owe fiduciary duties to the corporation (but usually not to the individual shareholders). Courts have held that officers and directors owe the following fiduciary duties to the corporation:

1. **Duty of Obedience.** This duty forbids so-called “*ultra vires*” acts or acts that lie outside the authority of a corporation.
2. **Duty of Care.** This duty requires diligence and prudence in managing the corporation’s affairs. However, the “business judgment rule” will often protect an officer or director for acts that are within the honest or good faith exercise of their business judgment.
3. **Duty of Loyalty.** This duty obligates actions be made in good faith and does not allow personal interests to prevail over the interests of the corporation. Examples of a

breach of this duty include self-dealing and usurpation of corporate opportunities.

Generally, but with notable exceptions, shareholders of a corporation do not owe one another fiduciary duties.

Limited Liability Companies

Various provisions of the Texas Business Organizations Code implicitly identify fiduciary duties that may exist for managers or managing members of an LLC. A governing person of an LLC (a manager, managing member, officer, etc.) is characterized as an agent of the LLC and therefore owes duties of care and loyalty to the LLC, but not necessarily to the individual members.

In certain circumstances, Texas courts have held that a fiduciary duty may be owed by one member to another. Such scenarios include: 1) where one member has sole control or management authority over the LLC; 2) where there is a close, personal relationship of trust and confidence between the members; and/or 3) where a majority interest owner is buying out or redeeming the ownership interest of a minority owner.

Partnerships: General (GP) & Limited (LP)

Partners (in a GP) and general partners (in an LP) are generally held to a fiduciary standard with respect to the partnership, and the other partners (in a GP) or limited partnership (in an LP). Generally, in an LP, limited partners should not owe fiduciary duties to the LP or to the other partners based on their status as limited partners since they are considered merely passive investors. Nonetheless, some Texas courts have imposed fiduciary duties on limited partners.



TAXATION

Sole Proprietorship/General Partnership

Sole proprietorships and general partnerships are treated similar as compared to “pass-thru” entities. A pass-thru (or flow-through) entity is an entity that passes its income, losses, deductions, or credits to its owners. For business owners that have chosen a sole proprietorship or a general partnership, there is no legal distinction between the business and the owners. The business is not taxed separately from the owners.

C Corporation

Under federal law, a corporation may be taxed as a corporation under subchapter C of the Internal Revenue Code or as a pass-thru entity under subchapter S of the Internal Revenue Code. The Internal Revenue Code provides that, unless the corporation elects otherwise, it will be taxed under subchapter C of the Internal Revenue Code. In a C corporation, net corporate income is 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.

S Corporation

Under subchapter S of the Internal Revenue Code, if a corporation wishes to be taxed as a subchapter S corporation, then the corporation will be taxed as a flow-through entity. In order to qualify for subchapter S treatment, the corporation must adhere to the following characteristics: 1) it must be a domestic corporation; 2) it must have no more than 75 shareholders; 3) the shareholders must be individuals, estates, certain exempt organizations, or qualified subchapter S trusts; 4) nonresident aliens may not be shareholders; 5) only one class of stock is permitted; and 6) its tax year must end on December 31, unless electing otherwise. A corporation electing to be taxed as an S corporation allows flow-through taxation so that net profits go straight to the shareholder’s individual income tax rather than being first taxed at the corporate level.

Filing Requirements

Both C and S corporations must file federal income tax returns. C corporations use Form 1120 to calculate their taxes. A business can file Form 2553 and elect to be taxed as an S corporation. S corporations file Form 1120-S as an information return and must also provide Form K-1 to each shareholder, so that each such shareholder may include the K-1 with their individual income tax return.

“...but in this world nothing can be said to be certain, except death and taxes.”

—Benjamin Franklin



TAXATION

Limited Liability Company

When it comes to taxation, the limited liability company is the most flexible:

1. **Sole proprietorship.** By default, if a single person or entity forms an LLC, then the taxation of such will be as a disregarded entity, or taxed as a sole proprietorship. Therefore, all of the company's income will be listed on Schedule C of the owner's 1040 individual income tax return. Although disregarded for tax purposes, the conditions of limited liability and the benefits thereof are honored under state law.
2. **Partnership.** By default, if two or more persons or entities form an LLC, then the taxation thereof will be deemed a partnership and the LLC will be required to file Form 1065, the form partnerships use to report income. The profits and losses of the LLC will flow through to the members and such profits and losses are reported on the K-1 which accompanies the Form 1065, and a K-1 is delivered to each member of the LLC.
3. **C Corporation.** An LLC may elect to be taxed as a corporation and file a Form 1120 to report LLC income. As a result, net income will be taxed inside the company at the lower corporate tax rate, but dividends paid to the members of the LLC will again be taxed to the members, as the members report such dividends on their individual 1040 income tax return.
4. **S Corporation.** An LLC may elect to be taxed as an association taxable as a corporation using Form 8832. If the LLC also files a 2553 election, it will be taxed as a Subchapter S corporation.

Entity Classification Elections

All business entities are assigned a default tax classification. For example, a single-person LLC is taxed as a disregarded entity, and a multi-member LLC is taxed as a partnership.

A form 8832 can be filed for an eligible business entity wanting to elect out of its default tax classification. Generally, any eligible business entity with at least two members may elect to be taxed either as a partnership or a corporation.

Limited Partnership

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 recording each partner's net income or loss. Such taxation is referred to as "flow-through" taxation, as it is not taxed at the partnership level but instead on the partner's individual income tax return. Partnership taxation offers unique flexibility with regard to the distribution of income and losses to the partners. This flexibility comes from the ability to determine the partner's distributive share of income or loss via the partnership agreement. Therefore, a partner's distributive share of income and or losses need not be the same for each item. Another key advantage of taxation under subchapter K involves the addition of partnership liabilities to the basis of the limited partners.

What is more, limited partnerships are particularly useful in the context of multi-generational business succession planning where estate, gift, and generation-skipping transfer taxes are at issue, as the value of limited partnership interest may be compressed for transfer tax purposes.



TAXATION: TEXAS FRANCHISE TAX

Franchise Tax

Pursuant to the Texas Tax Code, each taxable entity formed in Texas or doing business in Texas must file and pay franchise tax. Sole proprietorships and most traditional general partnerships are not considered taxable entities under the Texas Tax Code and are not subject to the franchise tax. However, most other business entities are subject to the franchise tax including corporations, limited liability companies, banks, professional corporations, and limited partnerships. Certain businesses may qualify as “passive entities” under the Texas Tax Code and be exempted from the franchise tax.

Calculation of the Franchise Tax

The Franchise tax is based on the taxable entity’s “margin.” Generally, that margin is calculated in one of the following ways:

- Total revenue times 70%;
- Total revenue minus costs of goods sold;
- Total revenue minus compensation; or
- Total revenue minus \$1 million.

For entities with revenue less than \$1,180,000, no franchise tax is due. The franchise tax rate of 0.75% is applied to businesses other than retail or wholesale businesses and 0.375% for retail or wholesale businesses.

Apportionment

Just because a business is formed in Texas, it does not automatically follow that the business will owe franchise taxes on its revenue. Generally, a Texas business will not have Texas franchise tax liability for gross receipts from business per-

formed outside the State of Texas. Under Texas law, the "margin," or an entity's revenue, on which the franchise tax is based, is apportioned based on the entity's gross receipts in-state versus out of state.

Texas Tax Code Section 171.106 states that, ". . . a taxable entity's margin is apportioned to this state to determine the amount of tax imposed under Section 171.002 by multiplying the margin by a fraction, the numerator of which is the taxable entity's gross receipts from business done in this state, as determined under Section 171.103, and the denominator of which is the taxable entity's gross receipts from its entire business, as determined under Section 171.105."

A Texas business that had fifty percent of its gross receipts from business done out of state would only have fifty percent of its margin subject to potential franchise tax.

Annual Filings

All business entities are required to file an Annual Franchise Tax Report by May 15 of each year, even if no taxes are owed.

The failure to timely file these tax reports can have enormous consequences. The Texas Secretary of State will terminate a business entity or forfeit its formation certificate for failure to file these reports.

Moreover, the Texas Tax Code obligates the Texas Comptroller to forfeit the limited liability privileges of a business entity for failure to timely file its reports. This can result in a member, partner, owner, officer, or director being personally liable for the debts of a business entity incurred during the period of forfeiture.



SERIES LLCs

What Is a Series LLC?

A Series LLC is a business entity by which multiple separate entities, known as “series,” may be formed under the umbrella of a single LLC, or Master LLC. Each series may have its own assets, liabilities, and members, but they still exist together under one Master LLC. Series LLC are particularly useful in managing multiple related businesses, like various rental properties or franchises.

Structure & Management

The basic structure of a Series LLC is relatively simple. A Master LLC acts as the umbrella under which all the series operate. From a legal perspective, the Series LLC is the Master LLC. Each series maintains its own independent management structures and may operate independently from the other series entities.

Why Form a Series LLC

One reason to form a Series LLC as opposed to traditional LLC is cost efficiency. Setting up multiple LLCs involves multiple formation fees and separate administrative costs. By utilizing a Series LLC, all of the series are under the umbrella of the Master LLC, thereby reducing formation and administrative costs.

Another reason to form a Series LLC is the additional layer of asset protection provided by its structure. In a Series LLC, liability is limited to the value of each individual series, generally protecting the other series. Further, many Series LLCs benefit from the increased flexibility that the divided structure

provides. Under a Series LLC, each series is afforded a greater degree of independence compared to traditional LLCs.

Important Considerations

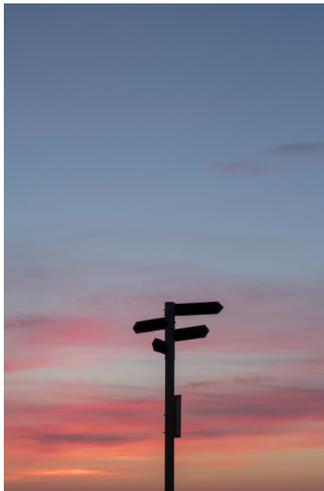
Whereas the formation of a Series LLC may simplify some aspects of management, the complexity requires skillful tax planning. Additionally, it is important for the relationship between the Master LLC and the individual series to be properly maintained to receive the benefits associated with the Series LLC.

For tax purposes, it is important to note that there is some variation in the treatment of Series LLCs. Although some may be considered a single entity and therefore only require a single filing as the income and expenses of the various series are consolidated, others may need to file separately for each individual series.

Another consideration to take into account is that not all states recognize series LLCs, and although this structure is available in Texas, such is not the case nationwide. What is more, real property held by a series is not eligible for a 1031 exchange. Given the complexities of Series LLCs, it is important to consult with a legal professional to decide whether or not the Series LLC is the option that will further the goals of your business.

“Success usually comes to those who are too busy to be looking for it.”

—Henry David Thoreau



BUSINESS SUCCESSION PLANNING

Multi-Generational Planning

For business owners, business succession planning is crucial. Statistics have shown that approximately seventy-five percent (75%) of all businesses fail to survive past the first generation of owners, and more than eighty-five percent (85%) fail by the third generation.

Multi-generational, business succession planning is complicated when estate and gift taxes, along with generation skipping transfer taxes factor in to the planning process. The well informed business owner will coordinate his estate plan with his business succession plan and may consider the use of dynasty trusts and grantor retained annuity trusts. What is more, business owners should consider forming a revocable trust as the centerpiece of their estate plan to keep the settlement of their estate private in the event of their death.

Buy Sell Agreements

A buy sell agreement is a contract among the co-owners of a business. Typically, such an agreement addresses what happens when one or more co-owners die or withdraw from the business. It can also govern situations where a co-owner declares bankruptcy or divorces their spouse.

The goal of a well-drafted buy sell agreement is to avoid future disputes and to maintain the success of the business by ensuring a reliable and predictable plan for successor ownership in case of death or unplanned events.

Buy sell agreements generally fall within one of two categories, but it is not unusual for a buy sell agreement to combine

elements of both categories in order to suit the needs of a particular business and its owners.

1. **Cross-Purchase Agreement.** This type of agreement permits one or more of the remaining co-owners to directly purchase the withdrawing owner's interest in the business; or
2. **Redemption Agreement.** This type of agreement provides that the business itself (e.g., the LLC, LP, or corporation) will buy back or redeem the withdrawing owner's interest in the business.

Passing Your Business to The Next Generation

Leaving a business to one's family or key employees can be a daunting task. Many business owners want the next generation to "earn" the business, not simply inherit it or receive it as a gift. Just as often, a business owner will face the dilemma of how to ensure that a key person have control of the business while providing the economic benefits of the business to a wider class of family members.

Pathways of Succession

A buy sell agreement, employee stock option plan, limited partnership agreement, or other contractual arrangement can provide a transactional pathway for a business owner to transfer the company to the next generation.

Also, utilizing (or converting to) an appropriate business entity—such as a limited partnership, can facilitate the transfer of the economic benefits of a business while retaining and/or centralizing the control over that business into the hands of a single or select group.



WHICH BUSINESS ENTITY IS MOST SUITABLE?

	SOLE PROPRIETORSHIP/ GENERAL PARTNERSHIP	Corporation	Limited Liability Company (LLC)	Limited Partnership (LP)
Formation & Filing Requirements	Formed when one or more individuals go into business together. Assumed Name Certificate filing and payment of filing fees	Formed by filing Articles of Incorporation, Certificate of Formation and filing fee with Secretary of State	Formed by filing Certificate of Formation and filing fee with Secretary of State	Formed by filing Certificate of Formation and filing fee 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	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. Like other business entities, LP is subject to franchise tax
Common Uses	Small businesses where business owns assets of little value and owners perform activities of business. Not appropriate for moderately wealthy 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	Families often use family limited partnerships for estate planning and asset protection purposes

