

# SPAIN HASTINGS WARD CAREY & CHAMBERS

Client Update: **Choice of Entity for Risk Management and Tax Savings**  
December 5, 2008

Times of economic dislocation are often accompanied by disruptions to business relationships and contractual arrangements. According to most economic estimations, we are already in the midst of a recession. To make matters worse, the tax burden on small businesses is expected to increase in the coming year. Now is the time to implement plans to minimize risks and reduce tax costs.

## **Risk Management**

Ordinarily, the shareholders of a corporation, members of a limited liability company or limited partners in a limited partnership are protected from personal liability arising from the activities of the business. *Generally*, such owners will not be personally liable for debts and obligations of the business in excess of the owner's investment in the entity.

If the business owner is sued personally, his or her judgment creditor will have different rights and remedies depending on the entity chosen for the business. In Texas, a judgment creditor may be able to force the sale of a shareholder's stock in a corporation to satisfy the judgment. As a result, the business owner may lose control over the business. To make matters worse, the owner would be subject to federal income tax on the forced sale, even if the owner did not receive any proceeds from the sale.

However, if the business were a limited liability corporation (LLC) or limited partnership (LP) with a properly drafted LLC or LP agreement, the judgment creditor would not be entitled to a forced sale of the partnership or company interests. Rather, the judgment creditor would be limited to a charging order. The charging order would entitle the creditor to receive the distributions from the business which were otherwise payable to the debtor. Managed carefully, the owner would retain his or her control over and draw a salary from the business.

## **Income & Payroll Tax Savings**

Limited partnerships, limited liability companies and S Corporations are pass-through entities for Federal income tax purposes. The income or loss of the business passes directly to the owners. While the income tax result may be approximately the same for each pass-through entity, the S Corporation offers potential payroll tax savings. In the case of S Corporations, unlike LLCs or LPs, amounts paid as corporate distributions are not subject to the payroll tax. With the cap on payroll tax expected to be increased from \$102,000 to \$250,000 in 2009, the ability to avoid payroll tax on a significant portion of business income makes S Corporations very attractive for small businesses.

## **The Best of Both Worlds**

To maximize the asset protection component of the LLC or LP and benefit from the payroll tax savings of an S Corporation, eligible businesses may form LLCs or LPs which can elect to be S Corporations under federal tax law.

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