

CHOICE OF ENTITY FOR INSURANCE AGENCIES IN TEXAS

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I.

Introduction

There are now quite a number of different ways an insurance agent in Texas can organize an insurance agency business. The options are: (i) sole proprietorship, (ii) general partnership, (iii) registered limited liability partnership, (iv) limited partnership, (v) limited liability company, (vi) regular "C" Corporation, and (vii) "S" Corporation. This article will briefly discuss various legal and practical issues that an insurance agent should consider in deciding whether to use an entity and, if so, deciding which type of entity is best for the particular insurance agent.

II.

Factors To Be Considered

The two primary factors to consider are: (i) who will have liability for torts (*i.e.*, negligence, deceptive trade practices, tortious interference with a contract) and contractual obligations of the business, and (ii) the tax consequences of the entity selection.

The liability issue primarily relates to the issue of whether an equity owner of the business will be vicariously liable for any obligations of the entity. In certain entities, this is the case, and in others it is not. This will be discussed more below.

The tax factor relates to two issues. First, certain entities are subject to the Texas franchise tax (the greater of 4.5% of taxable income or .25% of net taxable capital) and others are not. Second, certain entities result in taxation only of the ultimate owner, while other entities result in taxation both at the entity level and also with respect to distributions or dividends paid to the owners of the entity.

Other less important factors that differ from entity to entity are (i) transferability of ownership interests, (ii) ease of management, (iii) formation costs, and (iv) limitations on number and types of owners.

III.

The Liability Issue

To appreciate the liability issue, certain legal principles need to be reviewed.

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First, the type of entity makes a difference in whether an owner of the business is personally liable for debts and other liabilities of the business. With respect to a sole proprietorship and a general partnership, owners (*i.e.*, the sole proprietor of the proprietorship and the general partners of the partnership) **are vicariously liable** as a matter of law for all tort and contractual liabilities of the business. In a sole proprietorship (which involves the sole proprietor doing business under a business name without forming an entity), this means that any contracts entered into by the sole proprietor or by authorized employees of the business give rise to liabilities that can be satisfied, not only out of assets of the business, but also out of non-exempt assets of the owner of the business (*i.e.*, the sole proprietor). The same is true with respect to tort liabilities (or statutory liabilities such as taxes) of the sole proprietorship. With respect to a partnership, this means that any contracts entered into by any of the partners or by the authorized employees of the partnership and any torts committed by any of the general partners or by employees of the partnership within the ordinary course of the partnership's business give rise to claims of creditors that may be satisfied, not only out of the property of the partnership, but also out of all of the non-exempt assets of each general partner.

With respect to (i) registered limited liability partnerships (an "LLP"), (ii) a limited partnership, (iii) a limited liability company (an "LLC"), (iv) a corporation which has not made an IRS S-election (a "C-Corporation"), and (v) a corporation which has made an IRS S-election (an "S-Corporation"), the owners **are not vicariously liable** for contractual or tort liabilities of the entity. However, here an important observation must be made. It is that an owner can always be liable for torts that the owner personally commits while acting on behalf of the entity in which he owns an interest. For instance, if the owner negligently allows the business's vehicle he is driving to collide with another vehicle, the injured person can always recover against the negligent owner/driver because of the owner's negligence. In addition, under principles of law, requiring entities to be responsible for negligent acts committed by the entity's agents within the course of the entity's business, any valid claim may also be recoverable against the entity. A second observation is that owners can always contractually assume a debt of the entity (and quite often are required by a creditor to do so). In that case, the creditor can assert any unpaid claims against the owner's non-exempt personal assets as a result of the owner's contract with the creditor. The fact that the entity is primarily liable is no defense to the owner.

The net effect of the above is that use of certain legal structures (*i.e.*, a sole proprietorship or a general partnership) automatically results in vicarious personal liability of the owners of the business. However, others (*i.e.*, an LLP, limited partnership, LLC, C-Corporation or S-Corporation) do not impose vicarious liability (but, as noted above, also do not insulate an owner from the consequences of the owner's own torts or contracts).

IV. **Taxation**

The taxation factor has two parts to it: (i) first, applicability of the Texas franchise tax, and (ii) second, "double taxation" under federal income tax law. The following entities are not currently subject to the Texas franchise tax: (a) sole proprietorships, (b) general partnerships, (c) LLPs, and (d) limited partnerships. LLCs, C-Corporations and S-Corporations are subject to the Texas franchise tax. With respect to Limited Partnerships, frequent proposals have been

made in the past to subject them to the franchise tax. Therefore, the only business forms which will probably have some extended exemption from the Texas franchise tax are (i) sole proprietorships, (ii) general partnerships, and (iii) LLPs.

On the federal income tax side, the issue is basically whether the choice of entity allows for the possible “double taxation” of revenues of the entity. Double-taxation is the term for the possibility that revenue earned by the business may be taxed (i) first, at the entity level and (ii) second, on the income distributed to the owner(s) of the entity as distributions or dividends.

A C-Corporation presents the risk of double taxation. On the other hand, sole proprietorships, general partnerships, LLPs, limited partnerships, LLCs, and S-Corporations are not subject to taxation at the entity level. Instead, the entity (*i.e.*, all but the sole proprietorship) files an information tax return with the IRS and all taxable income is allocated to the owners in proportion to their interests in the entity. With respect to a sole proprietorship, the income of the business is simply reported as income of the owner/sole proprietor. However, it should be observed here that it is not necessarily the case that a C-Corporation will result in “double taxation” since a corporation is not required to pay any dividends. If a corporation can justify paying out all or most of its net income to its officers without such payments constituting “excessive compensation” under IRS rules, then all or most of the income of the business can be returned to the owners in the form of salaries. The result of doing so is that no dividends are paid, and, as a result, no second tax is paid on the dividends. However, where shareholders are not active in the business and as a result cannot be paid substantial salaries, dividends are the primary way to get income to passive shareholders.

V.

Making the Choice

The first issue is whether any of the entities that are exempt from the franchise tax (*i.e.*, a sole proprietorship, general partnership, limited partnership or LLP) offer sufficient liability protection to justify its use. With respect to the Limited Partnerships, since the owner(s) are the limited partner(s) and have no personal liability and the general partner can be a corporation or LLC (this avoids vicarious personal liability of the owners of the general partner), such a type of entity is the best of all worlds. It is both exempt from the Texas franchise tax and also provides maximum protection from personal liability of the owners. The only downside of a limited partnership is the higher formation costs. The filing fee is \$750 (as opposed to \$200 for an LLC and \$300 for a corporation), and two entities must be formed (*i.e.*, the limited partnership and an entity to be the general partner). However, it is quite probable that this exemption from the franchise tax will not continue for much longer based on legislation previously proposed. This largely is because of the perceived abuse by foreign corporations who operate in Texas through limited partnerships. So the person who chooses to do business as a limited partnership is faced with the strong possibility that the franchise tax exemption may be lost in the not too distant future. Sole proprietorships and general partnerships—although exempt from the Texas franchise tax—offer no liability protection. Therefore, these should generally only be used if a person is not worried about personal liability (either because of an absence of risk or adequate insurance).

If liability protection is not an issue, a sole proprietorship is the indicated choice of a single business owner since the continuing franchise tax exemption appears more likely and the entity form is simple and relatively inexpensive (*e.g.*, no filings with the Secretary of State are required). It is also the simplest from a federal tax perspective since no new tax return is needed (*i.e.*, income is reported on the individual owner's return) and there is no risk of "double taxation" of income. If there is more than one owner of the business, but no concern about liability, a general partnership is the best choice of entity since the Texas franchise tax does not apply to general partnerships and probably will not in the future. It also does not present any risk of double taxation since income of a partnership is not taxed at the partnership level but is instead allocated to be taxed to the partners in proportion to their partnership interests and any taxes due paid by the partners.

If there is concern about liability, the first entity that should be considered is a Texas Registered Limited Liability Partnership ("LLP"). This type of entity provides protection from vicarious liability of partners for torts committed by other partners or other representatives of the LLP *unless* such partner is directly involved in the tortious conduct or supervised the person who committed the tort and failed to take reasonable acts to prevent or correct the tortious conduct. Partners of an LLP are also not liable for debts of the LLP (unless they contractually bind themselves to be liable). From a tax perspective, an LLP is not subject to the Texas franchise tax and there do not appear to be any proposals to make LLPs subject to such tax. From a federal tax perspective, taxation is the same as with a general partnership. Thus, there is no risk of double taxation of income since income is allocated to the partners and not taxed at the LLP level. An annual filing with the Secretary of State is required, along with a filing fee of \$200 per partner. There is also a requirement that the LLP either (i) carry liability insurance of \$100,000, or (ii) establish a \$100,000 segregated fund or a \$100,000 letter of credit to pay tort claims.

If for some reason an LLP is not acceptable (*e.g.*, as a result of a desire for a more traditional type entity), then consideration should be given to a C-Corporation, S-Corporation or LLC. All of these will be subject to the Texas franchise tax unless gross receipts by the entity are less than \$150,000 (or the tax due is less than \$100). From a liability perspective, there is protection from vicarious liability of owners which is basically the same for all three types of entities. In making the decision between these three types of entities, federal taxation issues should be considered. A C-Corporation will be taxed at the entity level, and any dividends will be taxable to the shareholders. So, a C-Corporation should only be used if the owners are not concerned about double taxation. This could either be because the C-Corporation attractiveness (*e.g.*, its acceptance as a financing vehicle) outweighs the double-taxation issues, or, as discussed above, the owners are sufficiently involved in the business to justify salaries being paid to such persons (which are not so great as to be "excess compensation") in order to reduce net income of the corporation to \$0 or a small amount. If a C-Corporation is ruled out due to double-taxation concerns, the decision is then between S-Corporation and an LLC. Between the two, an LLC is probably preferable. While both avoid double taxation, there are no restrictions on the number or types of owners of an LLC. On the other hand, S-Corporations (i) cannot have certain types of shareholders (*e.g.*, generally corporations and other entities are prohibited), (ii) can only have one class of stock, and (iii) cannot have more than 75 shareholders. Finally, we note that it is a common practice for single business owners to use a single member LLC. A single member LLC is disregarded for federal tax purposes (but not Texas franchise tax purposes) and thus no

separate federal tax return is required for the LLC. On the other hand, it's respected for Texas law purposes and thus insulates the owner from vicarious contract or tort liability.

VI. **Conclusion**

So, which entity is best? As can be seen from the discussion above, the answer is "It depends." That is, it depends on the situation and concerns of the owner(s). A person deciding on an entity must consider what his or her concerns are and how the different characteristics of the various entity alternatives help allay those concerns.