TEXAS PROFESSIONAL CORPORATIONS – THE FUNDAMENTALS

A. General Characteristics.

A professional corporation is a corporation formed for the purpose of providing a professional service and governed as a professional entity under Title 7 of the BOC.\(^1\) A professional corporation, however, is specifically prohibited from providing certain types of professional service.\(^2\) A professional corporation may provide any professional service other than the practice of medicine by a physician, surgeon, or other doctor of medicine.\(^3\)

B. Owners.

Professional corporations are owned by shareholders.\(^4\) The definition of “shareholder” for a professional corporation does not differ from that of a for-profit corporation in Title 1.\(^5\) Title 7 places additional restrictions on the shareholders of a professional corporation. A person may be a shareholder of a professional corporation if the person meets Title 7’s definition of an authorized person.\(^6\) An authorized person is a professional individual or a professional organization.\(^7\) A professional individual is one who is licensed to provide in Texas or another jurisdiction the same professional service as is rendered by the professional corporation.\(^8\) A professional organization is a person other than an individual, whether nonprofit, for-profit, domestic, or foreign and including a nonprofit corporation or nonprofit association, that renders the same professional

\(^1\) Tex. Bus’n Org. Code § 301.003(3).
\(^2\) Id.
\(^3\) Id.
\(^4\) Id. § 1.002(81).
\(^5\) Id.
\(^6\) Id. § 301.007(a).
\(^7\) Id. § 301.004 (note that this term is specific to the professional corporation and a different definition of the same term applies to a professional association).
\(^8\) Id. § 301.003(5).
service as the professional corporation only through owners, members, managerial officials, employees, or agents, each of whom is a professional individual or a professional organization.\textsuperscript{9}

The definitions of authorized person and professional organization in the preceding paragraph are specific to the professional corporation and differ from the definition of such terms in relation to a professional association. The entity-specific definition of such terms permit professional corporations to have professional organizations as well as professional individuals as shareholders, subject to some restrictions.\textsuperscript{10} Professional organization ownership is not permitted in a professional association and serves as a major differentiating factor between these two professional entities. This ownership flexibility available to a professional corporation may, however, be affected by the election of “S” corporation status, which is discussed further in Section III(C)(ix).

An owner of a professional corporation who ceases to meet the definition of an authorized person must relinquish his ownership interest in the professional corporation.\textsuperscript{11} Additionally, a person who succeeds to the ownership interest of a shareholder must promptly relinquish such ownership interest in the professional corporation if the person is not an authorized person.\textsuperscript{12} Upon such occurrence, the professional corporation is required to purchase such non-authorized person’s ownership

\textsuperscript{9} Id. § 301.003(7).
\textsuperscript{10} Id. § 301.007(a) (“A person may be an owner of a professional entity…only if that person is an authorized person”); 301.004 (“For purposes of this title, a person is an authorized person with respect to…a professional corporation…if the person is a professional individual or professional organization.”).
\textsuperscript{11} Id. § 301.008(b).
\textsuperscript{12} Id. § 301.008(c).
interest in the professional corporation. In the event that there is only one shareholder of the professional corporation, and that shareholder is required to relinquish its financial interest, the BOC permits that shareholder to act as the managerial official or owner of the entity for the limited purposes of winding up the affairs of the professional corporation and selling the outstanding ownership interests and other assets of the professional corporation.

C. Governing Authority.

Professional corporations are governed by a board of directors. Similar to its corporate parent form, the shareholders of a professional corporation elect the directors. The same restrictions on who may be a governing person of a professional association apply to the board of directors of a professional corporation. The BOC states that an individual may be a director of a professional corporation only if such individual is licensed in Texas or another jurisdiction to provide the same professional service as is provided by the professional corporation. “Individual” is defined by the BOC as a natural person. Thus, no entity, regardless of its professional status, may be a director of a professional corporation. If, at any point, an individual fails to meet the definition of a professional individual, that individual must promptly resign from his or her director position with the professional corporation.

i. Officers.

13 Id. § 301.008(d).
14 Id. § 301.008(e).
15 Id. §§ 21.401; 303.001.
16 Id. §§ 21.405; 303.001.
17 Id. § 301.007(b).
18 Id.
19 Id. § 1.002(38).
20 Id. § 301.008(a).
Officers of a professional corporation are elected by the board of directors. As with the board of directors, the BOC places restrictions on who may be elected as an officer of a professional corporation. Section 301.007(7)(b) of the BOC states only a professional individual may be an officer of a professional corporation. A “professional individual” is an individual licensed to provide in Texas or another jurisdiction the same professional service as is rendered by that professional corporation. If, at any point, such individual fails to meet the definition of a professional individual, that individual must promptly resign from his or her officer position with the professional corporation.

D. Providing Professional Services.

A professional corporation may provide professional services in Texas only through owners, managerial officials, employees, or agents, each of whom is an authorized person. An authorized person for purposes of Section 301.006(b) is a professional individual or a professional organization. A “professional individual” is an individual who is licensed to provide in Texas or another jurisdiction the same professional service as is rendered by the professional corporation. A “professional organization” is a person other than an individual, whether nonprofit, for-profit, domestic, or foreign and including a nonprofit corporation or nonprofit association, that renders the same professional service as the professional corporation only through

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21 Id §§ 21.417; 303.001.
22 Id. § 301.007(b).
23 Id. § 301.003(5).
24 Id. § 301.008.
25 Id. § 301.006(b).
26 Id. § 301.004(2).
27 Id. § 301.003(5).
owners, members, managerial officials, employees, or agents, each of whom is a professional individual or a professional organization.28

Unlike a professional association, there is no specific statutory statement in the BOC that the owners, managerial officials, employees, or agents of the professional corporation who provide professional service in Texas be licensed to provide such professional services in Texas.29 This statement is not necessarily required for a professional corporation, however, as the term “professional service” includes this requirement. “Professional service” is defined as any type of service that requires, as a condition precedent to the rendering of the service, the obtaining of a license in Texas.30 Based on this definition, an owner, managerial official, employee, or agent of the professional corporation is prohibited from providing professional service in Texas unless that person becomes licensed in Texas by the appropriate licensing agency.

E. Joint Practice Professional Corporations.

Professionals, other than physicians, engaged in related mental health fields such as psychology, clinical social work, licensed professional counseling, and licensed professional28

28 Id. § 301.003(7)
29 See Tex. Bus. Orgs. Code Ann. § 301.006(a)(2) (“A professional association…may provide professional service in this state only though owners, managerial officials, employees, or agents, each of whom…is licensed in this state to provide the same professional service provided by the professional association.”); TBOC § 301.006(b) (“A professional entity, other than a professional association…may provide a professional service in this state only through owners, managerial officials, employees, or agents, each of whom is an authorized person.”); TBOC § 301.004 (“For purposes of this title, a person is an authorized person with respect to a professional corporation or professional limited liability company if the person is a professional individual or a professional organization.”); TBOC § 301.003(5) (“‘Professional individual,’ with respect to a professional entity, means an individual who is licensed to provide in this state or another jurisdiction the same professional service as is rendered by that professional entity.”); TBOC § 301.003(7) (“‘Professional organization,’ with respect to a professional corporation or professional limited liability company, means a person other than an individual, whether nonprofit, for-profit, domestic, or foreign and including a nonprofit corporation or nonprofit association, that renders the same professional service as the professional corporation or professional limited liability company only through owners, members, managerial officials, employees, or agents, each of whom is a professional individual or professional organization.”).
30 Id. § 301.003(8).
marriage and family therapy may form a professional corporation that is jointly owned by those practitioners to perform professional services that fall within the scope of practice of those practitioners.\textsuperscript{31} Physicians are not permitted to form a professional corporation as they are specifically excluded by such term’s definition.\textsuperscript{32} Licensed mental health professionals, however, are by definition non-physicians and subject to no such exclusion.\textsuperscript{33} A professional association is partially defined as an association formed for the purpose of providing the professional service rendered by a licensed mental health professional, but the definition does not state that it is the exclusive professional entity that may be formed for such purpose.\textsuperscript{34} Thus, it appears that licensed mental health professionals have a choice between a professional association and a professional corporation when deciding on a professional entity based on a for-profit corporation parent form.

A joint practice professional corporation is subject to the same restrictions on scope of practice as a joint practice professional association. When a joint practice professional corporation is formed, the authority of each of the practitioners is limited by the scope of practice of the respective practitioners and none can exercise control over the other’s clinical authority granted by their respective licenses, either through agreements, bylaws, directives, financial incentives, or other arrangements that would assert control over treatment decisions made by the practitioner.\textsuperscript{35} Additionally, the individual state agencies continue to exercise regulatory control over the professionals, in a joint practice

\begin{itemize}
\item \textsuperscript{31} Id. \textsection 301.012(b).
\item \textsuperscript{32} Id. \textsection 301.003(3).
\item \textsuperscript{33} Id. \textsection 301.003(1).
\item \textsuperscript{34} Id. \textsection 301.003(2).
\item \textsuperscript{35} Id. \textsection 301.012(f).
\end{itemize}
professional corporation, to whom they have issued licenses.\textsuperscript{36} A diagram of which professionals may form joint practice professional corporations is attached as Exhibit “B.”

\section*{F. Limited Liability.}

As stated previously, Title 7 of the BOC does not go into great detail on the subject of entity liability. Similar to a professional association, a professional corporation is jointly and severally liable for an error, omission, negligent or incompetent act, or malfeasance committed by a person who is an owner, managerial official, employee, or agent of the entity.\textsuperscript{37} Additionally, a professional corporation is jointly and severally liable for similar acts committed by a person who, while providing a professional service for the professional corporation or during the course of the person’s employment, commits the error, omission, negligent or incompetent act, or malfeasance.\textsuperscript{38} Any owners, managerial officials, and employees or agents of a professional corporation who did not commit the error, omission, negligent or incompetent act, or malfeasance, however, are not subject to such liability.

The corporation is the “parent form” of the professional corporation. It should therefore follow that the fundamental characteristics of the corporation should be the fundamental characteristics of the professional corporation. The most fundamental of these characteristics is that shareholders are ordinarily protected from personal liability.

\textsuperscript{36} \textit{Id.} § 301.012(g).
\textsuperscript{37} \textit{Id.} §301.010(a).
\textsuperscript{38} \textit{Id.} §301.010(a).
arising from the activities of the corporation.\textsuperscript{39} This holds true for the professional corporation. Section 21.223 of the BOC, applicable to professional corporations through Section 303.001 of the BOC, states that a holder of shares or any affiliate of such holder may not be held liable to the professional corporation or its obligees with respect to:

(1) the shares, other than the obligation to pay to the professional corporation the full amount of consideration for which the shares were or are to be issued;

(2) any contractual obligation of the professional corporation or any matter relating to or arising from the obligation on the basis that the holder is or was the alter ego of the professional corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar legal theory; or

(3) any obligation of the professional corporation on the basis of the failure of the professional corporation to observe any corporate formality, including the failure to:

(A) comply with the BOC or the certificate of formation or the bylaws of the professional corporation; or

(B) observe any requirement prescribed by the BOC or the certificate of formation or bylaws of the professional corporation for acts to be taken by the professional corporation or its directors or shareholders.\textsuperscript{40}

These limitations on liability of the shareholder of a professional corporation do not prevent or limit the liability of a holder, beneficial owner, subscriber, or affiliate if the


\textsuperscript{40} Tex. Bus. Orgs. Code Ann. §§ 21.223(a); 303.001.
obligee demonstrates that the holder, beneficial owner, subscriber, or affiliate caused the professional corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, beneficial owner, subscriber, or affiliate.41

While shareholders of professional corporations enjoy a similar limitation on liability to that of their corporate parent form, that limitation does not shield the shareholders from liability for their own negligence or malpractice in providing professional services. In a for-profit corporation, the shareholders may or may not provide personal service to the corporation’s clients or customers. The shareholders of a professional corporation, however, typically provide personal professional service to the professional corporation’s clients. The drafters of the BOC wanted to make clear that the limitation on the liability of a shareholder of a professional corporation did not limit a person’s rights to recover against a negligent professional. The BOC specifically provides that Title 7 does not affect in any way a person’s legal remedies against another person who commits an error, omission, negligent or incompetent act, or malfeasance while providing a professional service.42 A negligent professional, therefore, will be afforded no tort liability protection merely because he or she is a shareholder of a professional corporation through which professional service is provided.

G. Taxation.

i. Federal.

41 id. §§ 21.223(b); 301.001.
42 id. § 301.001(b)(2).
A professional corporation, similar to its corporate entity parent form, is by default taxed as a corporation for federal income tax purposes. The professional corporation’s earnings, therefore, are subject to “double taxation;” first at the corporate level, and then again at the shareholder level upon any distribution of dividends.

An eligible professional corporation may voluntarily elect to be classified as an “S” corporation by filing IRS Form 2553. Both the shareholders and their spouses must consent to such election. Classification of the professional corporation as an “S” corporation removes the corporate level tax and treats all income received by the professional corporation as if it was received by the shareholders personally. This income, whether or not it is distributed, is then taxed only at the shareholder level.

Not all professional corporations may elect “S” corporation status due to the restrictions placed on such entities by the Code. The following requirements must be met in order for the professional corporation to be eligible for “S” corporation status: (1) it must be a domestic entity; (2) it must have no more than one hundred (100) shareholders; (3) it must have no more than one class of stock, and (4) it must have no shareholders other than individuals who are residents or citizens of the United States. This final requirement would eliminate one of the levels of increased flexibility of the professional corporation versus the professional association, i.e., that the shareholders of

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45 Id.
professional corporations may be professional organizations as well as professional individuals.\textsuperscript{50}

Undistributed taxable income of an “S” corporation which is included in each shareholder’s gross income is not considered net earnings from the self employment of the shareholder.\textsuperscript{51} Dividends on shares of stock issued by a corporation are not considered self employment income under the Code.\textsuperscript{52} Distributions of accumulated income of an “S” corporation, therefore, are not subject to self employment tax so long as the shareholder is paid reasonable compensation for services provided to the corporation.\textsuperscript{53} If the IRS determines that these distributions are being paid out in lieu of compensation, however, such distributions may be recharacterized as compensation which is subject to FICA withholding.\textsuperscript{54}

ii. State.

Professional corporations, similar to professional associations, are taxable entities under the Texas Tax Code and therefore subject to the Texas Franchise Tax.\textsuperscript{55} The same breakdown of franchise tax responsibility applies to professional corporations as applies to professional associations. For a discussion of the franchise tax responsibility which is equally applicable to both professional corporations and professional associations, see the discussion of franchise tax responsibility of a professional association in Section III(B)(viii)(2).

\textsuperscript{50} Tex. Bus. Orgs. Code Ann. §§ 301.007(a); 301.004; 301.003(7).
\textsuperscript{51} Rev. Rul. 59-221 1959-1 C.B. 225.
\textsuperscript{52} I.R.C. § 1402(a)(2) (2008).
\textsuperscript{53} Rev. Rul. 74-44, 1974-1 C.B. 287.
\textsuperscript{54} Id.
\textsuperscript{55} See Note 77, supra.
**CONCLUSION**

Professional corporations have long been used by professionals in Texas to provide professional services through the familiar form of a corporation. Its familiar terminology, taxation, formalized structure make it a great fit for many professionals. While it is not a perfect fit for all circumstances, it remains both a popular and usefully professional entity form.