Would You Benefit From a Professional Law Corporation?

by Carolyn M. Dillinger

Introduction

This article compares using a professional law corporation with a sole proprietorship and a limited liability partnership. Specifically, it will focus on the advantages and disadvantages regarding liability and taxation.

The author largely draws on the Continuing Education of the Bar's *Organizing Corporations in California*, 3rd Edition, chapters one ("Considerations Before Incorporating") and six ("Professional Corporations"), *Marsh's California Corporation* Law, 4th Edition, chapter two ("Whether and Where to Incorporate") and twenty-four ("Professional Entities"), and *U.S. Master Tax Guide*, 2008, CCH Editorial Staff Publication.

This article does not examine the limited liability company because Corporations Code section 17375 states that a limited liability company may not be used to render professional services.

Basic Introduction to Business Structures

Sole Proprietorship

A sole proprietorship exists when a person does business as that person or with a fictitious business name. There is no separate business entity, such as a corporation or partnership.

Limited Liability Partnership

In 1995 the California legislature created the Registered Limited Liability Partnership (Marsh's p. 24-25). A limited liability partnership is a general partnership that engages in the practice of public accountancy or law, and that has registered with the Secretary of State. Limited liability partnerships are governed by the Corporations Code §16951-16962 (CEB p.35).

Professional Law Corporation

The 1968 enactment of the Moscone-Knox Professional Corporation Act, Corporations Code section13400-13410, allows professionals to render services through a professional corporation.

Liability

There are various types of liabilities involved in practicing law, including tort and contract. Tortious liability includes negligence, such as malpractice, car accidents, and slips and falls, as well as intentional torts. Contractual liability can include business obligations, such as commercial leases and employment contracts.

Sole Proprietorship

The sole proprietor is personally liable for the obligations of the business because he or she is the business. There is no limited liability partnership or corporate veil to hide behind. The sole proprietor may choose to cover his or her risks using various types of insurance policies, such as malpractice and general liability. Even with insurance policies, the risk to the sole proprietor is that the insurance policies would not fully cover the liability, because of exemptions, exclusions, or policy limits.

Limited Liability Partnership

A limited liability partnership (sometimes referred to herein as a "partnership") provides an attorney with much greater liability protection than the sole proprietorship. A partner is not liable for tortious liability, such as malpractice of the other partners, and contract liability of the partnership, if it has not been personally guaranteed by the partner and if the partner has not agreed to pay the contract liability (Corporations Code §16306).

The following types of liability cannot be limited by practicing either through a partnership or a professional corporation: (1) liability resulting from the partner or shareholder's own malpractice, (2) liability resulting from the malpractice of the employees that he or she supervises (CEB p. 714-715, Corporations Code §16306(e), Civil Code §2343(3)), and (3) liability resulting from the attorney's own contract liability.

In order to take advantage of the liability protection, a limited liability partnership must be registered with the Secretary of State (Corporations Code §16101(8)(A)) and have a currently effective certificate of registration issued by the State Bar (Corporations Code §16306(f)).

In order to register with the Secretary of State, a partnership must provide security for malpractice claims against it and its partners (Marsh p. 24-34, Corporations Code §16956(a)(2)). The partnership shall provide security by satisfying any of the following four options: (1) insurance, (2) collateral, (3) net worth, or (4) the alternative security requirement.

The partnership can obtain malpractice insurance in the amount of $100,000 multiplied by the number of licensed persons performing services on behalf of the partnership; but with a minimum requirement of $1 million and a maximum obligation of $7.5 million (Corporations Code §16956(a)(2)(A)).

In the alternative, the partnership can deposit money in a bank escrow, certificate of deposit, or other specified form of collateral, in the amount of $100,000 times the number of licensed persons performing services on behalf of the partnership; but with a minimum requirement of $1 million and a maximum obligation of $15 million (Corporations Code §16956(a)(2)(B).

Or, the partnership can confirm in prescribed form to the Secretary of State that "as of the most recently completed fiscal year of the partnership, it had a net worth equal to or exceeding fifteen million dollars ($15,000,000)." (Corporations Code §16956(a)(2)(D).

As an additional alternative, the partnership can aggregate its malpractice insurance coverage, collateral, and net worth, to satisfy the $15 million alternative security requirement. If there is a shortfall between the $15 million and the partnership's aggregate security, the partners are automatically deemed to have personally guaranteed the shortfall (Corporations Code §16956(a)(2)(C)). The partnership may indemnify the partners for this guarantee. Further, the LLP may choose the other options to avoid this option altogether.

Professional Law Corporation

According to my research, a professional law corporation provides the same liability protection as the limited liability partnership.

As explained above in connection with Limited Liability Partnerships, shareholders of professional law corporations may not limit certain types of liability by hiding behind the corporate veil. However, the corporate veil can protect the shareholders from the tort or contract liabilities of the corporation or other shareholders.

Shareholders in a professional law corporation must personally guarantee the malpractice obligations of their corporations within prescribed limits (CEB p. 715, B & P Code §6171(b), Law Corp R IV (B)(3)). The personal guarantee is a required part of the State Bar Application for Issuance of Registration as a Law Corporation.

The formula for calculating the amount that shareholders must personally guarantee is (a) per claim, $50,000 multiplied by the number of persons who practice law on behalf of the corporation, and (b) aggregate, $100,000 multiplied by the number of persons who practice law on behalf of the corporation. A person who practices law on behalf of the corporation is defined as "persons with whom the law corporation has established a law practice relationship of a continuous nature or who are held out by the corporation as being available to practice law on its behalf. This includes all attorneys practicing in a partnership…or association in which the corporation practices; employees; of counsel; contract attorneys; part-time attorneys and persons who practice law on behalf of the corporation in other jurisdictions, even if such members are *not* admitted to practice law in California." (State Bar of California Law Corporation Guarantee Worksheet.)

Because of this required guarantee, a professional law corporation is strongly recommended to have enough malpractice insurance to cover the maximum liability that the shareholders have personally guaranteed (Marsh p. 24-20).

Taxation

For purposes of this article, I have chosen to discuss four key taxation issues: (1) self-employment tax, (2) deductions/fringe benefits, (3) double taxation, and (4) retirement planning.

Sole Proprietorship

A sole proprietor reports her income on Schedule C of her personal tax return, Form 1040. Instead of processing payroll and paying payroll taxes on her income, the sole proprietor takes money from the business in the form of a "draw." Since payroll taxes are not taken out of the draw, a sole proprietor is required to pay self-employment taxes of 15.3%. This tax is charged on the net amount, after business expenses are deducted. While the self-employment tax is not a business expense, as it is for a professional law corporation, the sole proprietor is allowed to deduct half of his tax in figuring his adjusted gross income (taken from www.irs.gov obtained March 18, 2009).

The sole proprietor has little control over how much income is taxed as self-employment income because the income is whatever money remains after the proper deductions. On the other hand, the shareholder of a corporation has the ability to distinguish between salary, which is subject to payroll taxes, and dividends or distributions, which are not subject to payroll taxes. (*See* the discussion on subchapter S corporations and subchapter C corporations below.)

Similar to a corporation and partnership, a sole proprietor is allowed to deduct a wide range of business expenses. There are certain fringe benefits, discussed below under corporations, which a corporation can take advantage of, which a sole proprietor is not eligible to deduct.

A key advantage of a sole proprietor is that it is not subject to double taxation. Because the individual is the business, there is no separate entity to be taxed separately. Finally, a sole proprietor has limited retirement planning options, which include the IRA, and the SEP-IRA.

In general, the sole proprietor vehicle does not provide your tax professional with the range of tax planning strategies available through the professional law corporation. These tax planning strategies include the ability to allocate wages and distribution or dividends, to deduct certain fringe benefits, and to utilize certain retirement planning options.

Limited Liability Partnership

A limited liability partnership is a pass-through entity, which means that the profit and losses pass through the partnership and are allocated amongst the partners.

This pass-through status can be helpful because the partnership avoids the double taxation of a subchapter C corporation. Under California law, the partnership or corporation is required to pay taxes to the California Franchise Tax Board. The minimum annual fee is $800 per year.

The pass-through status can be a disadvantage to a profitable business that reinvests a significant portion of its profits back into the partnership. This is because the partners are taxed on their allocable share of the profits even if the partners have not received a cash distribution. This concept of having tax liability when money was not tangibly received is sometimes referred to as phantom tax.

Partners can be subject to self-employment taxes depending upon how the partnership chooses to structure payments to the partners. A partner's eligible share of income may be treated in one of three ways: (1) as net earnings from self-employment, (2) as salary or wages, or (3) as distributable shares of partnership income. The key is that your tax professional has options and can help you structure your respective income in an advantageous manner.

The partnership is not subject to the double taxation of a subchapter C corporation. Although the partnership is not required to pay federal income tax, the partnership must file a Form 1065 information return with the Internal Revenue Service.

There is a concept applicable to partnerships called guaranteed payments. A guaranteed payment is any fixed payment to partners for services or for the use of capital made without regard to partnership income. An example of a guaranteed payment is if the partnership agreement states that each partner is guaranteed to receive a base payment of $5,000 per month regardless of how much income the partnership has earned for that particular month, quarter, or year. Guaranteed payments are regarded as ordinary income to the recipient and can be deductible by the partnership as long as the payments qualify as ordinary and necessary business expenses. The value of fringe benefits provided to a partner for service rendered in the capacity as a partner is generally treated as a guaranteed payment.

This ability to make guaranteed payments is a key factor that sets partnerships apart from other entities. The partnership is able to take advantage of some, but not all, of the deductions and fringe benefits that are allowed by a professional law corporation. There are also differences in the retirement planning strategies that are available to partners rather than to shareholders in a professional law corporation.

Professional Law Corporation

A professional law corporation can be structured as a subchapter C corporation or a subchapter S corporation. A corporation is automatically a C corporation unless the shareholders file a Form 2553 to elect subchapter S status. There are certain requirements for electing subchapter S status which include that a corporation have only one class of shares, have no more than 100 shareholders, have no nonresident alien shareholders, and each shareholder consent to electing subchapter S status.

The shareholders of a corporation, regardless of C or S status, are employees of the corporation. Because they pay payroll taxes on their salary, the shareholders are not subject to self-employment taxes. The benefit of paying payroll taxes is that the employer's half of the taxes, 7.65 percent, is a deductible business expense. This is more beneficial than the sole proprietorship where the sole proprietor is allowed to adjust his or her adjusted gross income by half.

The C corporation is subject to double taxation. First, a federal corporate income tax is imposed on the net earnings; then, after the earnings are distributed to shareholders as dividends, each shareholder pays taxes on his or her share of the dividends. There is some relief available for the shareholders. With the help of your tax professional, a C corporation can reduce, or even eliminate, its federal income tax liability by distributing its income as salary to shareholders. This can reduce taxation at the corporate level and minimize the negative impact of the double taxation.

The S corporation is not subject to double taxation. Instead, similar to the partnership, the shareholders are taxed on their share of the entity's earnings.

The C corporation provides the maximum tax benefit with fringe benefits. A full analysis is beyond the scope of this article; however, some of the fringe benefits that are allowed under a C corporation include the full deductibility of health insurance premiums, the deductibility of parking expenses, and some qualified retirement plan advantages (CEB 714). It is important that you discuss your specific goals with your tax professional so that he or she can walk you through the details of these benefits.

The S corporation provides more tax benefit with fringe benefits than a sole proprietorship, but less than the C corporation. It is noteworthy that tax treatment of fringe benefits paid to employees of an S corporation is different for shareholders than for other employees. Fringe benefits paid to S corporation employees who are not shareholders, or to shareholders who own two percent or less of the outstanding S corporation stock, can be excluded from the employees' taxable wages and are deductible as fringe benefits by the corporation. However, shareholders who own more than two percent of the S corporation stock are not treated as employees for fringe benefit purposes, and their fringe benefits may not be tax free. This is an important distinction because many shareholders of small law firms will own more than two percent of the stock and this will affect the deductibility of fringe benefits. Shareholders with more than two percent ownership are treated in the same manner as partners in a partnership.

A shareholder employee who owns more than two percent of the S corporation stock can deduct 100 percent of the amount paid for medical insurance for herself, her spouse and dependents.

Scenarios

One attorney firm

A one attorney firm can be structured as a sole proprietor or as a professional law corporation. Depending upon the gross revenue of the firm, and other factors, it may be beneficial for the firm to be structured as a corporation. The professional law corporation can take advantage of structuring salary and dividends or distribution, deducting certain fringe benefits, and utilizing certain vehicles for retirement planning.

Two to nine attorney firm

A two attorney firm can be structured as a limited liability partnership or as a professional law corporation. The partnership and corporation provide the same liability protection from the vicarious liability of the other partners and the debts of the partnership. However, the partnership must satisfy the security requirement by obtaining the minimum amount of malpractice insurance, providing the appropriate collateral, or verifying that it has a net worth of at least fifteen million dollars. Otherwise, the partners will be deemed to automatically personally guarantee the shortfall between the fifteen million security requirement and the partnership's aggregate total of malpractice insurance, collateral, and net worth. The partnership can indemnify the partner for this personal guarantee, but it would be better to not have to provide this guarantee.

Compare the difference between the guarantee requirement of the shareholders in the corporation with that requirement in a limited liability partnership. A professional law corporation with two shareholder attorneys is required to guarantee $100,000 per claim ($50,000 times 2) and $200,000 aggregate ($100,000 times 2). However, if those same two attorneys were structured as a limited liability partnership and chose to satisfy the security requirement via insurance, the partnership would be required to obtain the minimum $1 million insurance coverage. The professional law corporation would not have to meet $1 million in coverage to cover the personal guarantee of its shareholders, unless the corporation had ten licensed attorneys working on its behalf ($100,000 times 10). You should speak with your insurance agent to price the difference in malpractice insurance coverage. If the difference is significant, based upon this calculation, in addition to other tax differences, it may be beneficial for the smaller firm to form a professional law corporation instead of a limited liability partnership.

Ten or more attorney firm

For the firm with at least ten attorneys, the decision of whether to form a limited liability partnership or a professional law corporation will probably come down to a detailed discussion with your tax professional. In order to be prepared for that discussion, it is important for the attorneys to understand their financial goals, along with the basics on salary allocation, fringe benefits, and retirement planning,

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