Choice of Entity

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I. Overview of Entities

The entity selection process is one of the first steps in the formation of any business, including law firms. There are several legal, tax and general business implications of each type of entity that must be carefully evaluated to determine the most appropriate organizational form. The focus of this section is on the tax and general business considerations of the various entities. The only reference to the legal considerations is whether or not an entity will provide some form of legal liability protection.

Law firms have several entities to choose from. The taxation mechanics and general business characteristics of these entities are as follows:

A. The sole-proprietorship (SP) is the most basic form of business organization where a single owner carries on a business, personally takes title of all business property and is personally liable for all business obligations. The tax reporting of the business income and deductions are included with the individual owner’s individual income tax returns. Therefore, the owner pays income tax and self-employment tax (social security) on the net taxable income of the business with his or her individual income tax returns.

B. The general partnership is also a basic form of business where “two or more persons carry on as co-owners of a business for a profit” (i.e. co-proprietorship). The general partners share the business profits, ownership of all business property and liability for all business obligations in accordance with their partnership agreement. Partnership agreements can be drafted to define and structure the true essence of most partner business arrangements. Complex profit, loss, equity and liability sharing arrangements coupled with a multitude of potential transactions between partners in business make the partnership a potentially complex entity for

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2 Uniform Partnership Act, Section 6(1)
tax purposes. The tax laws and regulations are structured to handle the treatment of all types of partnership transactions, which at times can be somewhat cumbersome. However, the tax treatment of basic partnership transactions is usually quite simple. The tax reporting of the income and deductions of the partnership are reported on a partnership tax return and then “passed through” to the individual partners for taxation on their individual income tax returns. Therefore, the partners pay income tax and self-employment tax (social security) on their allocation of the net taxable income of the business with their individual income tax returns.

C. The Registered Professional Limited Liability Partnership is a special type of general partnership that exists under the laws of most states for professionals practicing in groups.\(^3\) The Limited Liability Company is an entity created under state law for all business types except where limitations set by professional licensing boards prohibit their use. The Limited Liability Partnership (LLP) and Limited Liability Company (LLC) provide some form of legal liability protection to the professional partners or members for the malpractice of other professionals and certain other liabilities, the level of which differs from state to state.\(^4\) Similar to general partnerships, LLP and LLC agreements can be drafted to define and structure the true essence of most business arrangements. For tax purposes, the LLP and LLC can be treated in same manner using the same forms as a general partnership.

D. The Professional Corporation is an entity created under state law for the purpose of one or more professional individuals to carry on a business for profit.\(^5\) Similar to LLPs and LLCs, professional corporations offer some legal protection to the professional partners for the malpractice of other professionals and certain other liabilities.\(^6\) Shareholder agreements can be drafted to define and structure the true essence of most business arrangements. However, the adoption of certain arrangements can create different classes of stock. S Corporations are only allowed for entities with one class of stock and thus are less flexible than C Corporations.

\(^3\) Commerce Clearing House, Federal Tax Service (2016)
In general, a Corporation can be classified as a C Corporation or an S Corporation, the definitions of which are as follows:

1. **The C Corporation** is a corporation that has not elected S status. The tax reporting of the income and deductions of the corporation are reported and taxed on the corporate level tax returns. The federal tax rate for a C Corporation that is classified as a “qualified personal service corporation” is a flat 35% as opposed to the tiered rate structure from 15% to 39% for regular corporations. A “qualified personal service corporation” is one that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts or consulting.7

   In addition to the corporate level tax, any dividends paid out of the earnings and profits of the corporation are taxed to the shareholders on their individual income tax returns. Thus, double taxation. In an incorporated Law Firm, the shareholders and officers or key employees are one in the same. Therefore, most of the profits in the business can be distributed in the form of payroll to avoid double taxation. This officer and employee compensation is deducted from the corporate taxable income, thus avoiding double taxation on the distribution of net income. However, excessive compensation rules, the timing and availability of cash flow and several other factors may prohibit the elimination of double taxation through shareholder payroll.

   In most cases, in an incorporated law firm, the shareholders will pay tax on most of their income through regular payroll deductions under which they have their income tax and social security tax withheld. Then, the corporation is liable for the matching of social security and the payment of unemployment taxes. The remaining net income taxed at the corporate level is taxed again when distributed to the shareholders unless an S Election is made.

2. **The S Corporation** is a corporation that has qualified, timely elected and been approved by the IRS to be treated as a Small Business Corporation. The taxable income and deductions of

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the S Corporation are reported on the S Corporation return and then “passed through” to the shareholders for taxation on their individual income tax returns. Therefore, the shareholders pay income tax on their allocation of the net taxable income of the business with their individual income tax returns. Unlike partnerships, this net income passed through to the shareholders is not subject to self-employment tax. However, the shareholders actively participating in the firm must be reasonably compensated through payroll prior to any additional amount being deemed shareholder profit “passed through” to the shareholders. For most corporations that qualify, the S Corporation is the most tax beneficial route.

To be eligible to elect S Corporation status, a corporation must be a “small business corporation.” Thus, the following requirements under Internal Revenue Code Section 1361(b) must be met:

a. The corporation must be a US domestic corporation.
b. It must have 100 or fewer shareholders.
   1. at any time during the year\(^8\)
   2. husband and wife count as one\(^9\)
c. The shareholders may only be individuals, estates or certain trusts. Partnerships & corporations can not be shareholders.
d. The S Corporation can not have a shareholder that is a nonresident alien.
e. The corporation can have only one class of stock.

The S election is made by a qualifying corporation, with the unanimous consent of the shareholders, by filing IRS Form 2553 by the 15\(^{th}\) day of the 3\(^{rd}\) month of the tax year.\(^{10}\)

II. Classification of an LLC as a Partnership

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\(^8\) Rev. Rul. 78-390, 1978-2, CB 220
\(^9\) IRC Section 1361(c)(1)
The first concept that needs to be understood when comparing several entities is the IRS rationale for the classification of an entity as an association taxable as a corporation. Under Internal Revenue Code Regulations Section 301.7701-2(a), six characteristics are taken as the criteria for distinguishing corporations from other organizations. These are: (1) the presence of associates; (2) an objective to carry on business and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.

Prior to the check-the-box regulations, to be an association taxable as a corporation, an organization must have more corporate characteristics than non-corporate characteristics. Since both partnerships and corporations have associates and a business objective, only the last 4 characteristics will differentiate the two. Therefore, under these rules, to avoid classification as a corporation by the IRS, an entity must not have more than 2 of the 4 business characteristics.\(^{11}\)

A sole-proprietorship lacks all 4 characteristics except centralization of management. A partnership can lack all 4 characteristics as the partners have equal say in management. However, a partnership agreement can be drafted to implement centralized management, continuity of life or free transferability of ownership, but more than two will cause the IRS to consider it an association taxable as a corporation.\(^{12}\) An LLP and LLC has limited liability. Therefore, it should not have more than one of the three other business corporate characteristics or it would be a corporation for tax purposes under these rules.

However, effective January 1, 1997, under the check-the-box regulations, an entity generally can elect to be treated as a partnership for federal income tax purposes.\(^{13}\) If an election is not made under these rules, then the six corporate characteristics will be analyzed for classifying the entity as a partnership or a corporation for tax purposes. The election is made by filing IRS Form 8832. Certain default provisions exist where unless an election is made, a domestic eligible entity is (1) a partnership if it has two or more members or (2) disregarded as an entity separate from its owner if it has a single owner.

### III. Analysis of Several Factors

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\(^{11}\) McDaniel, Ault, McMahon & Simmons, Federal Income Taxation of Business Organizations (2016)

\(^{12}\) Id.

\(^{13}\) IRC Regulations Section 301.7701
The chart in Exhibit 1 compares the consequences of each entity for several legal, tax and general business factors. Many other factors do exist that have not been considered in this chart. Also, many further considerations exist that have not been discussed below.

The entities analyzed are (1) the Sole-Proprietorship (SP); (2) the General Partnership (GP); (3) the Limited Liability Partnership or Limited Liability Company (LLP/LLC); (4) the S Corporation (S Corp); and 5) the C Corporation (C Corp). The LLP and LLC have primarily the same tax implications and therefore are not considered separately for this purpose. All characteristics assume that the company is organized under the laws of Massachusetts and only operates within Massachusetts. Multi-state operations have many further legal, tax and business factors to be considered.

A. The first factor to consider is the number of owners. If you intend to operate without partners, you need to compare the SP, LLC, S Corp and C Corp. If you intend to have partners, the SP is not applicable, but the GP is. If you intend to have more than 100 partners, foreign partners, corporate partners, etc., then the firm will not qualify for the S Corp election.

B. Legal liability is the most important consideration for any type of business in the selection of an entity. If liability protection is deemed necessary, only the LLP/LLC vs. the C Corp or S Corp is applicable. If not, then the number of owners will determine the type of entity to choose (SP vs. GP). To weigh the cost benefits of legal liability protection, the costs of formation, annual filing fees and compliance costs need to be considered. If legal liability protection is determined to be an issue, these incremental costs are quite often considered cost effective.

C. Continuity of life, transferability of interests and centralization of management are listed in the exhibit to illustrate the IRS corporate characteristics as discussed in Part II. There may be important legal and business reasons for these factors that outweigh the tax

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15 IRC Section 1361(b)
consequences. In such instances, classification as a corporation may be necessary. Then, the only consideration is whether to be an S Corp or a C Corp.

D. Flexibility of owner agreements may be a significant factor to be considered. Partnership agreements can be structured to capture the true essence of the partner agreements with complex arrangements for the sharing of capital, liabilities, profits and losses. For example, partner agreements can be structured to compensate the partners for gross billings, profit realization, hours worked, interest on capital infusions, etc. Such compensating factors can be essential to the success of a professional service firm. In a C Corp, such arrangements can be made with the use of compensation agreements, different classes of stock, shareholder loan agreements, etc. However, a C Corp is less flexible than a partnership for very complex agreements. An S Corp is very limited, as the creation of a second class of stock is cause for termination of the S Corporation status.

E. Cost of formation, annual filing fees and compliance costs are usually of greater concern to small organizations without the availability of legal counsel due to the legal charges necessary for the drafting of documents. However, excluding the legal costs, the LLP/LLC registration fee is $500.00 and the minimum corporate organization fee is $275.00 in Massachusetts. The annual fees and minimum state tax amount to $581 for a corporation and $500 for an LLP/LLC. The compliance costs of preparing the tax returns are usually similar for partnerships and corporations, but sole proprietorships are less costly. In addition, if the only employees of the company are the owners, the compliance costs of running a payroll, as required in a corporation, must be considered.

F. The potential for double taxation is usually enough of an argument for the S Corp election. However, careful planning and the use of officer compensation in a C Corp can potentially avoid double taxation by distributing all profits to the shareholder-employees in the form of payroll. Attorneys and most other service organizations should only consider a C Corp when unusual circumstances exist that make such an entity more appropriate.

G. The pass-through of income by a GP, LLP/LLC and S Corp is only of benefit to avoid double taxation and to allow the combination of deductible business losses with taxable income from other sources
on your individual income tax return. In a C Corp, losses may generally only be deducted on the individual income tax return when the stock is sold or deemed worthless.\(^\text{17}\) The losses in a GP, LLP/LLC and S Corp are deductible on the individual income tax return to the extent that the owner has basis. The intent is to only allow the owner to deduct the losses that he or she has funded. In very simple terms for purposes of illustrating this point, basis is the owner’s capital investment: liabilities incurred and cumulative income and expense items passed through. In a partnership, the partners receive basis for all debts incurred by the partnership, as they are liable for all debts. In an S Corporation, shareholders only receive basis for their loans to the corporation, as they may not be liable for the other debts of the corporation. Even if the shareholder has personally signed for the corporation’s debt, such debt may not be included in basis.\(^\text{18}\)

H. C Corps classified as a “qualified personal service corporation” as discussed in Part I, pay federal tax at a flat rate of 35\%.\(^\text{19}\) The SP, GP and LLP/LLC have no entity-level taxes. S Corps have several entity-level taxes including a tax on built-in gains (a/k/a the BIG tax) and a tax on excess net passive income (a/k/a the Sting tax).\(^\text{20}\) These taxes are only an issue when an existing C Corp converts to an S Corp and under certain circumstances. The purpose of the BIG tax is to prevent a corporation from avoiding the corporate level tax on prior earnings and profits by electing S status. The Sting tax is only an issue when the S Corp accumulates a certain level of passive investment activity. The purpose of this tax is to prevent a corporation from avoiding the Personal Holding company tax by electing S Status. In addition, S Corp distributions can be taxed when such amounts exceed the shareholders’ basis (i.e. distributions from corporate debt). These and several other S Corp level taxes need to be considered when comparing the S Corp to the LLP/LLC.

I. In an S Corp, if profits are earned in excess of the shareholder-employees’ fair market value, such excess can be distributed to the shareholders as S Corp distributions not subject to social security

\(^{17}\) McDaniel, Ault, McMahon & Simmons, Federal Income Taxation of Business Organizations (2016)
\(^{18}\) Walter & Ley v. Commr., TC Memo, 1993-306
\(^{20}\) Commerce Clearing House, Federal Tax Service (2016)
and medicare taxes. For more established firms, this will lead only to avoiding of the medicare tax of 2.9% or 3.8% for an individual making over $200,000 (married, filing jointly making over $250,000) as the social security tax is only on wages up to $127,200 for 2017. If substantial profits are predicted, these 2.9% (3.8%) savings in an S Corp can be quite beneficial as compared to the SP, GP or LLP where all income is subject.

J. In a SP, GP and LLP/LLC, the income is taken in the form of a draw and not through payroll. The reason is that a person cannot be an employee of himself or herself. Therefore, the owners’ income is not subject to unemployment taxes. In a corporation, the owners are both shareholders and employees. Therefore, their wages are subject to unemployment taxes. In Massachusetts, depending on the company experience rating, the unemployment tax is approximately 3.0% on the first $15,000 of wages. The Federal unemployment tax is usually .6% on the first $7,000 of wages. Therefore, unemployment taxes cost approximately $492 per person. This cost would be reasonable if the shareholder-employee could collect unemployment in a time of financial trouble. However, it is very difficult for shareholder-employees to collect unemployment in Massachusetts.

K. In a SP, GP, LLP/LLC and S Corp, the Massachusetts income taxes are paid at the individual level at a rate of 5.05% in 2017. In a C Corp, the Massachusetts corporate level tax is 8% on income plus .26% on tangible property or net worth. Dividends issued are then taxed in Massachusetts at 5.05% in 2017. Thus, double taxation at the state level. S Corps with income in excess of $6M pay a corporate level tax in Massachusetts at a rate of 1.93% on 2016 net taxable income and those with income in excess of $9M pay a corporate level tax at a rate of 2.9% on 2016 net taxable income. Therefore, both types of corporations can have significant tax costs at the state level.

L. A benefit of the C Corp is the deductibility of fringe benefits at the corporate level. Health insurance and other benefits are not deductible by partnerships and S Corps (for shareholders with 2% or more ownership) and must be added to the compensation of the

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shareholders. However, health insurance is allowed as a deduction on the individual income tax returns. Overall, the deductibility of certain benefits in a C Corporation is not worth the risk of double taxation.

M. A personal finance consideration is the manner in which taxes are paid. In a SP, GP or LLP/LLC, the income taxes of the owners are paid quarterly. In a corporation, most of the income taxes are paid through payroll, which is paid either monthly or weekly. For those starting a business with limited cash flow or significant personal financial needs, the accumulation of tax funds for 3 months can be tempting when other obligations are mounting. Many people find the funds unavailable at the end of the quarter and possibly at the end of the year. Then, with the accumulation of significant interest and penalties, it can become difficult to catch up. With this in mind, the payment of taxes on a weekly basis can be more cost effective due to the discipline factor. Others with the availability of cash may consider this an opportunity to invest the funds and earn money. However, if the payroll route is chosen and the funds are unavailable to pay the weekly or monthly taxes, the late payment penalties on payroll taxes are far greater than the underpayment of quarterly estimated tax penalties. Therefore, you should carefully consider your cash situation and personal finance habits when selecting an entity.

Overall, each entity has several minor advantages and disadvantages to be considered. It is recommended that you review each consideration and determine which items are significant and should be evaluated. However, be careful not to discount several factors, which may be cumulatively significant. As a final note, don’t just focus on the short term. Attempting to change your entity status in the future can be costly due to potential taxes on the liquidation of an entity with an accumulation of value.