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## **Entity Selection Consideration for Law Firms**

### **Sole Proprietorship**

A sole proprietorship is a business that has not incorporated which is owned by one person. If you start a law practice with no partners and do not incorporate, then your law practice is considered a sole proprietorship. As a sole proprietor you are required to obtain an occupational license in the city and/ or county where your law office is located. Generally, you must apply in person for the occupational license. In a sole proprietorship, there may be an unlimited number of employees, but there is only one owner. If there are any employees in addition to yourself, you must apply for a Federal Employer Identification Number issued by the Internal Revenue Service. This is like a social security number, but for a business. You apply for a Federal Employer Identification Number by filing Form SS-4 with the Internal Revenue Service at <http://www.irs.gov/pub/irs-pdf/fss4.pdf> . Technically, a sole proprietorship is not considered a separate legal entity, and there is no legal separation between you as the sole proprietor and your law practice business. In a sole proprietorship, you are financially responsible for all liabilities of your law practice, and all of your personal assets are subject to seizure or lien by creditors. This is one of the major drawbacks to operating your law practice as a sole proprietorship.

When you file your personal tax return every year on Form 1040, you will attach Schedule C to that return to report your profit or loss from operation of your sole proprietorship law practice. In addition to paying income tax on your earnings from your sole proprietorship law practice, you are required to pay a 15.3% self-employment tax on those earnings. (The self-employment tax is called social security/ medicare tax in the context of a professional association.) The 15.3% self-employment tax is comprised of a 12.4% social security tax and a 2.9% medicare tax. Self-employment income higher than \$106,800 in the year 2009 is exempt from the 12.4% social security portion of the tax. The 2.9% medicare portion of the tax, however, is applied to all self-employment income, without an upper limit. Note that by operating your law practice as a sole proprietorship, you forfeit certain tax advantages that are available for professional associations. For example, with a sole proprietorship you cannot lower payments for social security tax and medicare tax (as you can with an S corporation). The tax advantages available for professional associations are discussed in greater detail below.

## **General Partnership**

A general partnership is a business that has not incorporated which is owned by two or more persons. The owners of a general partnership are called general partners. If you start a law practice with any partners and do not incorporate, then your law practice is considered a general partnership. A general partnership is subject to the occupational license issue discussed above in the sole proprietorship section. General partnerships are governed by Part II of Chapter 620, Florida Statutes.

In a general partnership, each partner is jointly and severally responsible for all liabilities of the law practice business, and all personal assets of each partner are subject to seizure or lien by creditors. This is one of the major draw backs to operating your law practice as a general partnership. Why would you ever want to put yourself in a position where your financial upside is limited to your percentage interest in the general partnership, but your financial risk is unlimited and affected by liabilities that arise in the ordinary course of business and from the possible malpractice of one of your partners? You should never be a partner in your individual name in any general partnership. The risks are too great.

A general partnership must apply for a Federal Employer Identification Number and file a federal tax return every year on Form 1065. A general partnership is considered a pass-through entity under state and federal tax law. A general partnership does not pay tax. The annual profit of a general partnership is reported to each partner on Schedule K-1, and the partners pay income tax on their respective distributive share of the profits reported on that schedule.

## **Limited Liability Partnership**

A general partnership has the option of becoming a registered limited liability partnership if it files with the state a Partnership Registration Statement under Part II of Chapter 620, Florida Statutes, and a separate form called a Statement of Qualification in accordance with Section 620.9001, Florida Statutes. A limited partnership -- which is formed by filing with the state a Certificate of Limited Partnership under Part I of Chapter 620, Florida Statutes, and usually is designated in Florida by the name ending "L.P." --also has the option of becoming a registered limited liability limited partnership if it files the Statement of Qualification. The most common name ending for a general partnership or limited partnership that files the Statement of Qualification is "LLP."

In a limited partnership, there must be at least one limited partner and at least one general partner. Each limited partner has protection against personal liability for the liabilities of the limited partnership. If the Statement of Qualification is not filed, each general partner has unlimited personal liability for the liabilities of the limited partnership. A limited partnership that files the Statement of Qualification must use the LLLP name ending. For example, a limited partnership named "Smith L.P." that files the Statement of Qualification will be renamed "Smith LLLP." The filing of that statement protects each general partner against personal liability for the liabilities of the limited partnership, while the LLP status is active.

Florida law was changed substantially in 1999 to make LLPs more attractive for the practice of law. A general partnership with LLP status may be used to operate a law practice in Florida, but neither a limited partnership nor a registered limited liability limited partnership are specifically permitted under Rule 4-8.6(a) of the Rules Regulating The Florida Bar for the operation of a law practice.

Under Section 620.8306, Florida Statutes, a general partner is not personally liable for any obligation of the partnership, whether arising in contract, tort or otherwise, while it is an LLP. The protection against personal liability provided by an LLP is equivalent to that provided by a P.A. or a P.L., with one important exception. The state will administratively revoke the Statement of Qualification (and the LLP status) if the LLP annual report is not filed on time. The annual report is due May 1 of each year following the calendar year after the Statement of Qualification is filed. If the LLP status is revoked for failure to file the annual report and reinstatement is not applied for within two years after the revocation date, each general partner is jointly and severally responsible for all liabilities of the law practice business that arise after the revocation. If you decide to operate your law practice as an LLP, it is crucial that the responsibility for filing the annual report be given to an employee or partner with initiative who is very skilled at handling administrative details in a timely manner. Otherwise, you run the risk that the LLP status and protection of the general partners will be forfeited for failure to file the annual report.

### **Professional Association**

A professional association is a professional service corporation that is formed by filing with the state standard articles of incorporation that specify the type of profession that will be practiced. The most common name ending for a professional association is "P.A." (Note that "Inc." or "Corp." or "Co." are the most common name endings for a corporation that does not provide professional services, as that term is defined in Chapter 621, Florida Statutes.) The owners of a professional association are called shareholders and, to avoid a possible "piercing of the corporate veil" argument, should not refer to themselves or each other as partners. A professional association is subject to the occupational license issue discussed above in the sole proprietorship section, and must apply for a Federal Employer Identification Number. A professional association owned by one person who is the sole shareholder, director and officer, provides the same benefits as a professional association that has many shareholders, directors and officers. Professional associations are governed by Chapters 607 and 621, Florida Statutes.

As a shareholder in a professional association, you do not have personal liability for liabilities that arise in the ordinary course of business or from the malpractice of other attorneys at your law firm. This is one of the major benefits of operating your law practice as a professional association. Note that you remain responsible for any liabilities due to your own legal malpractice and that of associate attorneys who you supervise directly, so it is a good idea for your firm to obtain legal malpractice insurance. (A list of legal malpractice insurance carriers is available at the LOMAS pages at [http://www.flabar.org/.](http://www.flabar.org/))

Since each shareholder is protected against personal liability for obligations of the law practice business, operating your law practice through a professional association helps give you peace of mind, in contrast to a sole proprietorship or general partnership. If your professional association is administratively dissolved for failure to file the annual report, it may be reinstated at any time by paying the applicable reinstatement fee and filing the applicable form. The reinstatement is retroactive to the date of administrative dissolution, and the professional association continues as if the administrative dissolution had never occurred.

With a professional association, failure to file the annual report results in paying a higher filing fee. Contrast that to an LLP, where failure to file the annual report can result in loss of LLP status and personal liability of each partner for the liabilities of the partnership. For this reason, it is safer to operate your law practice as a professional association instead of as an LLP.

Other benefits of forming a professional association can include greater tax deductions for health insurance and medical expenses (with a C corporation) and lower payments for social security tax and medicare tax (with an S corporation). A professional association is taxed either as a C corporation or an S corporation. The terms C corporation and S corporation refer to the way in which the professional association is taxed. Your professional association will be taxed as a C corporation unless Form 2553 is filed with the Internal Revenue Service. To elect tax treatment as an S corporation, Form 2553 must be filed within 75 days after your professional association has shareholders, has assets, or starts doing business, whichever occurs first. You can download Form 2553 at [http:// www.CorporateCreations.com/irs.html](http://www.CorporateCreations.com/irs.html).

A professional association that is a C corporation files a federal tax return every year on Form 1120. There is a corporate level income tax on the profits of a C corporation. In addition, if a dividend is paid to shareholders from retained earnings, the dividend is included on the personal tax return of each shareholder. Thus, the profits of a C corporation are subject to potential double taxation. For this reason, you should not operate your professional association as a C corporation unless your professional association will show little or no annual profit. This can be accomplished by increasing the compensation paid by the professional association to its shareholder-employees, since such compensation is a business expense and reduces the annual profit.

A professional association that is an S corporation files a federal tax return every year on Form 1120S. An S corporation is a pass-through entity under Florida and federal tax law. For an S corporation, there is no Florida corporate income tax. Instead, a pro rata portion of the annual profit or loss of the S corporation is reported to each shareholder on Schedule K-1 and included on the personal tax return of each shareholder. Many law practices in Florida are operated as professional associations that are S corporations.

With an S corporation, the distribution of S corporation profits is exempt from the 15.3% social security/medicare tax that is imposed on compensation income, and you can implement a tax savings strategy commonly called "wage reduction." With the wage reduction strategy, the shareholder of an S corporation saves \$1530 for every \$10,000 profit distribution ( $\$10,000 \times 15.3\% = \$1530$ ) because the entire profit distribution is exempt from the social security/medicare tax.

For example, assume that you are the sole shareholder and employee of a professional association that has annual revenue of \$87,000 and no expenses, except the payment of your compensation. Assume also that your compensation is paid once per year on December 31. On that day, assume you receive two checks from your professional association. Assume the first check is in the amount of \$77,000 and is paid to you as compensation for your work during the year. That first check is subject to the social security/ medicare tax. Assume the second check is in the amount of \$10,000 and is paid to you as a profit distribution. That second check is exempt from the social security/medicare tax, and you save \$1530. If you implement the wage reduction strategy, remember that you must be paid a reasonable wage. Because of the tax savings, virtually all attorneys benefit by operating their law practice as a professional association that is an S corporation rather than as a sole proprietorship.

### **Professional Limited Liability Company**

A professional limited liability company is formed by filing with the state standard articles of organization that specify the type of profession that will be practiced. The most common name ending for a professional limited liability company is "P.L." (Note that "LLC" is the most common name ending for a limited liability company that does not provide professional services.) The owners of a professional limited liability company are called members. A professional limited liability company is subject to the occupational license issue discussed above in the sole proprietorship section. Professional limited liability companies are governed by Chapters 608 and 621, Florida Statutes.

Just as with a professional association, as a member in a professional limited liability company, you do not have personal liability for liabilities that arise in the ordinary course of business or from the malpractice of other attorneys at your law firm. This is one of the major benefits of operating your law practice as a professional limited liability company. As is the case in a professional association, you remain responsible for any liabilities due to your own legal malpractice and that of associate attorneys who you supervise directly, so it is a good idea for your firm to obtain legal malpractice insurance. Since each member is protected against personal liability for obligations of the law practice business, operating your law practice through a professional limited liability company helps give you peace of mind. The protection against personal liability provided by a professional limited liability company is equivalent to that provided by a professional association.

Also like a professional association, if your professional limited liability company is administratively dissolved for failure to file the annual report, it may be reinstated at any time by paying the applicable reinstatement fee and filing the applicable form. The reinstatement is retroactive to the date of administrative dissolution, and the professional limited liability company continues as if the administrative dissolution had never occurred. With a professional limited liability company, failure to file the annual report results in paying a higher filing fee. Contrast that to an LLP, where failure to file the annual report may have more adverse consequences since it can result in loss of LLP status and personal liability of each partner for the liabilities of the partnership. For this reason, it is safer to operate your law practice as a professional limited liability company instead of as an LLP.

A professional limited liability company is considered a pass-through entity under state and federal tax law. For tax purposes, a professional limited liability company is treated like a partnership and does not pay tax. A professional limited liability company applies for a Federal Employer Identification Number by filing Form SS-4, and files a federal tax return every year on Form 1065. The annual profit of a professional limited liability company is reported to each member on Schedule K-1, and the members pay income tax on their respective distributive share of the profits reported on that schedule. Note that a single member professional limited liability company is a "disregarded entity" for federal tax purposes, and the profit or loss from operation of such a P.L. is reported on Schedule C, which is attached to the member's Form 1040 personal tax return every year.

If the owners of your law practice desire to pursue different tax planning strategies, you can accomplish that goal by forming a professional limited liability company to operate your law practice, which can be owned by entities that are owned by the individual attorneys. For example, in a two member P.L., one member may be a C corporation and the other member may be an S corporation. Those member entities are owned by the individual attorneys. This structure enables each attorney to pursue a different tax planning strategy: the attorney who owns the C corporation can deduct 100% of medical expenses and health insurance, and the attorney who owns the S corporation can pursue the wage reduction tax strategy discussed above in the professional association section. Both attorneys can achieve their own tax planning goals. You should be aware that some states, such as California, prohibit the use of a professional limited liability company for the practice of law, but permit the use of an LLP for the practice of law. If you operate an interstate law practice with some attorneys practicing law in Florida and other attorneys practicing law in California, you can operate that practice as an LLP (instead of a professional limited liability company) to enable the partners to pursue their own individual tax planning strategies and to provide the partners with greater protection against personal liability.