

CHOICE OF ENTITY FOR A LEGAL PRACTICE IN OREGON

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NOTE: This outline is a general overview of the issues involved in entity formation for attorneys practicing in Oregon. It does not purport to offer legal advice. Practitioners should conduct their own independent research and consult with appropriate business and tax professionals before making any decisions as to form of entity.

I. AVAILABLE FORMS OF PRACTICE IN OREGON

A. Sole Professional Practice

1. Sole Proprietorship
2. Single Shareholder Professional Corporation ("PC")
 - a. "C" corporation
 - b. "S" corporation
3. Single Member Limited Liability Company ("LLC")

B. Multiple Professional Practice

1. General Partnership ("GP")
2. Limited Liability Partnership ("LLP")
3. Multiple Shareholder PC
 - a. "C" corporation
 - b. "S" corporation
4. Multiple Member LLC
5. GP, LLP or LLC with Single Shareholder PCs or Single Member LLCs as partners or members (a "Multiple Tier Organization")

II. PERSONAL LIABILITY IN OREGON

A. Types of Liability

1. Professional Liability (Malpractice)
 - a. Direct (including liability for subordinates under direct control and supervision)
 - b. Vicarious
2. Other (Non-professional) Tort Liability
 - a. Direct
 - b. Vicarious
3. Contractual Liability

B. Sole Practitioners and Partners of GP

Attorneys who practice as sole practitioners or partners in a professional GP have unlimited personal liability for all types of liability of the practice, including acts or omissions of associates/employees. In a GP, a partner may have rights to indemnification or contribution from other partners, but as to creditors, the partner has unlimited joint and several liability.

C. Single Shareholder PC or Single Member LLC

An attorney who is the sole shareholder of a PC or the sole member of an LLC will have:

1. Unlimited personal liability for professional liability (because such liability will always be direct, unless perhaps liability arises from acts of employees);
2. Unlimited personal liability for direct non-professional tort liability (e.g., the attorney negligently bumps the client through a plate glass window);
3. No personal liability for non-professional torts committed by employees (unless the claimant can establish negligent delegation or supervision); and
4. No personal liability for contractual liability (absent personal guarantees).

Query: Is a single shareholder/member always responsible for supervision of negligent employees/associates? If not, personal liability may be limited as described in D.2. below.

D. Partner in LLP, Member in Multiple Member LLC, Shareholder in Multiple Shareholder PC

An attorney who is an owner of an interest in an LLP, LLC, or PC, will have:

1. Unlimited personal liability for direct professional liability resulting from his or her own acts or those of others under his or her direct supervision and control;
2. Limited personal liability for vicarious professional liability resulting from acts of other partners, shareholders, members or employees, notwithstanding the lack of direct supervision and control. Vicarious liability limited to \$450,000 (with a \$3.1 million limit for entire firm) in a year;
3. Unlimited personal liability for direct non-professional tort liability; and
4. No personal liability for non-professional torts committed by others in firm or for contractual liability.

Note that a Multiple Tier Organization may eliminate vicarious professional liability.

E. Impact of Personal Liability on Choice of Entity

For purposes of limiting personal liability, any form of practice other than a sole proprietorship or GP provides essentially the same protection. In Oregon, the playing field for PCs, LLPs and LLCs is level.

F. Multiple Tier Organizations

An attorney who is the sole owner of a PC or LLC that is a shareholder, partner or member in a PC, LLP or LLC will be treated in a manner similar to the attorney referenced in Section D above, except that as to items 1 and 2 above, personal liability MAY be avoided in some circumstances:

1. The statute requires for direct, supervisory or vicarious liability that the services in question be rendered on behalf of the entity. If we are focusing on the liability of the owner of a single owner entity practicing as a shareholder, partner or member of a PC, LLP or LLC, are the services in question being rendered on behalf of the PC, LLP or LLC with whom the client has the direct relationship or on behalf of the single owner entity?
2. Further, if the statute refers to the umbrella entity and every owner of such entity is a single owner entity, there would not be any "licensed" owner of the umbrella entity to which the statute would impose direct or vicarious liability because entities are not licensed, only individuals are licensed.
3. On the other hand if one penetrates the tiers to the negligent licensee's single owner entity and imposes direct liability on that owner, the statute's reference to "other shareholders [members or partners]" may not cover the other licensees since they are not co-owners in the negligent party's entity on whose behalf the negligent licensee is performing services.
4. Under either view, looking at the entity being held out to the public as the main firm or looking at the entity wholly-owned by the negligent attorney through which he or she practices, a strong argument can be made that the statute precludes imposing personal liability on the other owners of the lower tier entities which have ownership interests in the firm.

III. **TAX TREATMENT**

A. Sole Proprietorship

A sole proprietor reports income on Schedule C on his or her personal tax return for the practice. There is no separate tax return for the practice. The sole practitioner with employees should get an employer identification number (EIN) for reporting payroll of employees. All earned income is subject to self employment tax (similar to FICA).

B. Single Member LLC

A single member LLC is generally disregarded for income tax purposes (but not for liability protection purposes). An attorney practicing in a single member LLC generally reports income in the same manner as a sole proprietor and should get an EIN for the LLC if the attorney has any employees. All earned income is subject to self employment tax (similar to FICA). (A single member LLC is allowed to elect to be treated as a corporation for tax purposes. If such an election were made, the tax treatment would be as described below for PCs.)

C. GPs, LLPs, Multiple Member LLCs

All GPs, LLPs, and Multiple Member LLCs are treated as partnerships for income tax purposes (unless the entity elects to be treated as a corporation.) The partnership files a separate partnership tax return (Form 1065) but does not itself pay any tax. The partnership income is allocated among the partners or members and reported on Schedule K-1 to the Form 1065. Each partner reports the income on his or her Schedule K-1 on his or her personal income tax return. Partnership tax provisions of subchapter K of the Internal Revenue Code apply equally to all GPs, LLPs, and Multiple Member LLCs. All earned income is subject to self employment tax (similar to FICA). Certain post year-end adjustments of income shares can be made. (A multiple member LLC is allowed to elect to be treated as a corporation for tax purposes. If such an election were made, the tax treatment would be as described below for PCs.)

D. PCs (Single and Multiple Shareholder)(Including LLCs that elect to be treated as corporations)

1. "C" Corporation. A regular, or "C" corporation, is subject to a corporate level tax. The corporation files its own tax return (Form 1120) and pays tax on its taxable income, i.e., income after the payment of salaries, bonuses, and other deductible expenses. Corporate taxable income that is paid out to shareholders is subject to another tax at the shareholder level (the so-called "double tax").

Typically, to reduce the risk of double taxation PCs operated as "C" corporations pay out salaries and bonuses to their shareholder employees in an amount sufficient to reduce the corporation's taxable income to near zero. Salary payments, including salary payments to employees who are also shareholders, are (subject to reasonable compensation limitations) deductible by the PC in computing its taxable income. This takes some careful planning at the end of the corporate year and the calendar year. Special rules apply to year-end selection and tax planning.

2. "S" Corporations. A PC that timely elects to be treated as an "S" corporation files a corporate tax return (Form 1120S) but generally does not itself pay tax. Rather, the income, after salaries, bonuses, and other deductible expenses, is allocated among the shareholders (in proportion to their number of shares) and reported on the shareholders' Schedule K-1 (and then on their individual tax returns). Thus, S corporation's earnings generally are not subject to a double tax and they do not have to be as careful in computing and timing year-end bonuses. However, there are special restrictions on choice of year end, shareholder qualifications and the types of economic distinctions that may be made between shareholders.

A shareholder-employee of an "S" corporation PC receives two types of income from the PC: (a) salary payments (that are subject to withholding and social security taxes) and (b) "S" corporation actual or constructive dividends (the net income that flows through on Schedule K-1 regardless of whether or when it is distributed to shareholders). The dividend income is not subject to income tax withholding and provided at least adequate compensation is paid, it is not subject to social security taxes. However, only salary and bonus payments, and not actual or constructive dividend payments, may be taken into consideration for retirement plan contribution purposes.

E. Tax Benefit Differences

1. Pension Plans. Although "C" corporations used to have a significant additional benefit with respect to pension and profit sharing plan contribution limits, these differences have been eliminated. The limits are now the same for sole proprietorships, partnerships, "C" corporations, and "S" corporations.

2. Health Care Expenses. “C” corporations have an advantage for health care expenses. Effectively, shareholder-employees of a “C” corporation PC can both deduct health insurance premiums and participate in cafeteria plans (so-called “flexible benefit or 125 plans”). Self-employed persons (which for this purpose include sole proprietors, partners of a GP or an LLP and members of an LLC) and employees with at least a certain interest in an “S” corporation cannot participate in a cafeteria plan and the amount of their health insurance premiums that they can deduct is limited by their earned income.
3. FICA Benefit. Shareholder-employees of PCs (“C” or “S” corporations) have the ability to avoid social security taxes on income amounts received or allocated to them as dividends rather than compensation provided a reasonable amount of compensation is paid.
4. Miscellaneous “C” Corporation Benefits. PCs operated as “C” corporations have some other miscellaneous benefits over partnerships, sole proprietorships, and “S” corporations.
 - Deduction for disability insurance premiums (but, if the PC claims the deduction, the benefits will be taxable to the shareholder-employee, regardless of “C” or “S” status);
 - Deduction for parking expense;
 - Deduction for group term life insurance (for coverage up to \$50,000).
5. Retirement Payments. Partnerships (including LLPs and multiple member LLCs that do not elect corporate tax treatment) have an advantage in structuring retirement payments to former partners. Payments for good will and receivables can be structured to be deductible by the partnership. PCs cannot deduct any payments for redemption of stock.

Any tax advice contained herein is not a “covered opinion” under Circular 230 and therefore cannot be used, by itself, for the purpose of avoiding any tax penalties that may be imposed.

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