

# **Choice of Entity for Your Practice**

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Two of the most common questions that we get are: “Do I need to form a corporation, or other entity for my practice and, if so, what type of entity should I form?”

First, let me dispel a popular misconception: if you are a solo practitioner you do NOT, necessarily, need to form an entity. As long as liability or blanket insurance coverage is in place, you will be protected from claims of garden-variety negligence; such as a slip and fall in your parking lot, or lobby. It is also worth mentioning that none of the entities designed to limit liability will protect you from claims of professional negligence (i.e. medical malpractice). In all fifty states, these claims can go through your entity and get to your personal assets.

Having stated the above, it IS necessary that you form an entity if you have a partnership or facility sharing arrangement.

Let’s review the various types of business entities.

*Sole Proprietorship (SP):* An SP is not an entity at all. Any time that you engage in a business venture for the purpose of making a profit you are a sole proprietor. The example that I have frequently used at our workshops, is my lemonade stand. When I had my lemonade stand, as a boy, I was an SP. This is a very flexible way of doing business. I can take money from the till and put it into my piggy bank and vice versa. I don’t need to file anything with the state and I don’t need to jump through a lot of regulatory “hoops”. Pretty cool!

The draw-back of the SP is a function of this same flexibility. Since I and my business are one in the same the law views us this way as well. If a little old lady were to slip on a lemon peel that I negligently dropped on the ground, she would have recourse to my business assets; BUT, she would also have recourse to my personal assets (i.e. my piggy bank).

This exposure of one’s personal assets to business liability is the primary drawback of the SP; but, as I mentioned above, this is mitigated by having proper liability insurance in place.

*Partnership:* Let’s say that my friend Billy, who lives down the street, has seen the success of my lemonade stand and wants in! We agree that we will work together to grow the business and we will share profits. A partnership operates like a sole proprietorship with more than one owner. It has all of the advantages of flexibility that the SP has. It is a “flow through” entity; just like an SP. All income or losses run straight through to the partners’ tax returns.

The disadvantage to the partnership form of entity is that, like the SP, it does not protect the partners from personal exposure for the business' liability.

But there's an even worse feature possessed by partnerships; vicarious liability. Vicarious Liability is a legal concept which makes me liable for the negligent acts of my partner. So, if I am away at summer camp and Billy is "minding the store" in my absence and the same little old lady comes by and slips on the lemon peel; the business will be liable and so will Billy.

But guess what; I will be liable as well. Even though I wasn't in the area when the negligence occurred, I will be held liable for my partner's negligence and my piggy bank will be vulnerable.

*Corporations:* Corporations have been around since 1600 and the charter of the British East India Company. Corporations are creatures of state law. Corporations are persons. They are not natural persons; but persons nevertheless. They can own property; sue and be sued; have tax ID numbers; pay taxes, etc. They also have a nice quality which we natural persons don't possess; immortality. As long as shareholders continue to keep the corporation alive, it will continue to exist.

Since the law views the corporation as a separate person, it can be held liable for its negligent acts and, therefore, the shareholders may be insulated from exposure of their personal assets. If the Tommy Cooper Lemonade Stand, Inc. negligently leaves a lemon peel on the ground and the little old lady breaks her hip, she may sue the corporation and recover against it; but can she get at my piggy bank, or Billy's? The answer is no!

Have I complied with all of the requirements that state law around corporations? Have I kept my minute books up to date; showing regular shareholder meetings and memorializing board resolutions? Have I paid all state license and registration fees in a timely manner?

If my corporation is non-compliant; or if I have been treating the corporation as my own private piggy bank; then the court will do the same and "pierce the corporate veil" and access my personal assets. You may be organized as a corporation; but if you are not complying with all state law compliance requirements, your limited liability protection may fail; just when you need it!

The fact that corporations are separate persons also means that they will be taxed as persons. If a corporation shows net income at the end of the year, it will pay income tax on that income. This is why your accountant may be telling you that you need to "bonus out" any profits, over and above the salary that you were paid on your W-2. Dental practices organized as corporations are defined by the Internal Revenue Code as "Personal Service Corporations" (PSCs) and are taxed at a flat rate of 35%.

This means that profits left in the corporation will be taxed at 35% and then, when the income is distributed to the shareholder, another tax of 15 to 20% will be levied. This results in a cumulative tax in excess of 50%.

*S Corps:* the above discussion has related to the traditional corporation that we all think of when we think of a Microsoft, or other public company. The S Corp was created to allow professionals to have the limited liability protection of a corporation; but the convenience of a flow-through entity; like a partnership. The S Corp. this is not another type of corporation. It is the same corporation under state law. This is simply an election made by the shareholder(s) to be taxed like a partnership. The form is filed with the IRS and allows the corporation to avoid the potential double taxation described above. S Corps have been very popular with dental professionals over the last twenty years. While S Corps go a long way to providing the business owner with the flow-through qualities of a partnership; it protects the shareholder's assets from exposure to litigant's claims against himself, or fellow shareholders.

*Professional Limited Liability Companies (PLLCs):* If there is such a thing as "having your cake and eating it", the LLC would be it. This type of entity provides the professional with the limited liability of a corporation; but has the flexibility of a partnership or sole proprietorship. LLCs do not have the compliance requirements of corporations and are very simple to manage.

Unfortunately, not all states allow doctors to practice in this form. California and Kentucky are two examples of states that do not permit medical or dental professionals to own their practice in this type of entity.

Don't worry; we know how to work around this type of problem. We can use a partnership of S Corps. This allows us to retain the flexibility of a partnership; with the limited liability of a corporation. It is a kind of "simulated" PLLC.

In any state that *does* permit the operation of a practice in a PLLC format; this is my preference. As a matter of fact, most new professional entities formed are formed as PLLCs.

*Bottom line:* Talk to your tax advisor about this topic and recognize that there is a great deal of misinformation out there. If you have any questions or confusion, give us a call.