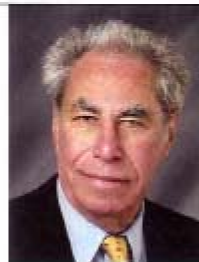


Choosing the Entity for Your Practice

| By Martin L. Fried, Esq., of Counsel
Hancock & Estabrook, LLP

A physician choosing an entity in which to conduct a practice must take into account the liability and tax issues associated with that choice. This article will explore those issues.

Although sole practitioners can use an unincorporated sole proprietorship, a single-member limited liability company or a corporation as the practice vehicle, no physician should ever practice as an unincorporated sole proprietor. There is no limit to the personal liability of a sole proprietor for debts and liabilities incurred in the practice.

A practitioner group can choose to practice as a general partnership, a multimember limited liability company or limited liability partnership or a corporation. No group should ever practice as a general partnership because, as in the case of a sole proprietorship, there is no limitation on the personal liability of the partners.

Therefore, the choice of entity is in large measure one that is tax-driven; other costs, such as filing fees, are not a major concern.

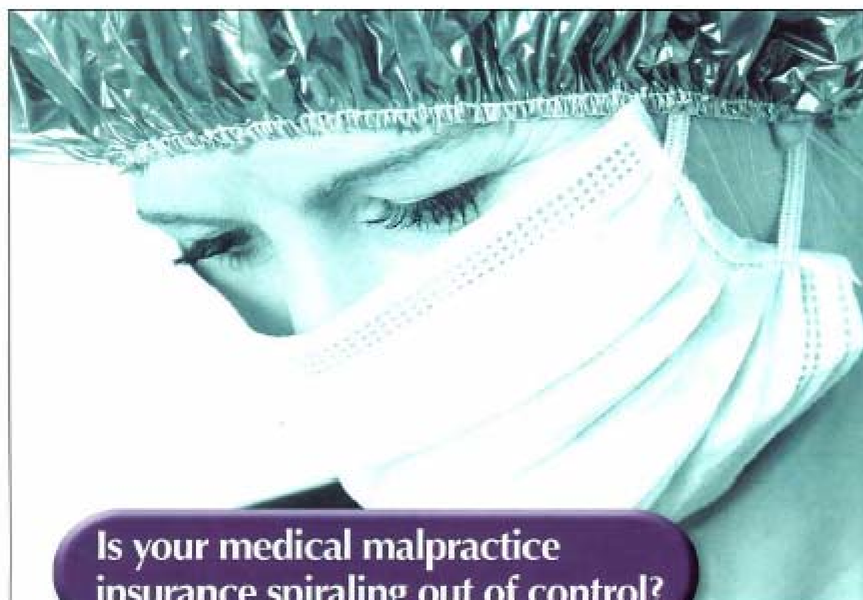
INCOME TAX CONSIDERATIONS

Single-Member Limited Liability Company

A single-member limited liability company is treated as a disregarded entity for income tax purposes unless the member decides that the entity should be taxed as a corporation (using what is called the "check-the-box" income tax regulations). This means that all of the net income of the practice is taxed to the practitioner, whether distributed or not. No return is filed for the company; the practitioner reports all of the income and all of the expenses on schedule C of his or her individual form 1040 for the year. What we have, in effect, is a tax picture identical with the one that would arise if the physician were a sole proprietor, but without the specter of unlimited liability.

Multimember Limited Liability Company or Partnership

A multimember limited liability company or limited liability partnership is treated as a partnership for income tax purposes unless the members choose to be taxed as a



A new alternative is FINALLY here in N.Y.
Stop the increases! Save $ now!

The J. M Woodworth, Inc. Risk Retention Group has hit the ground running. By utilizing alternatives with proven results, such as our "Paid Claims Coverage" form, we can succeed where others have struggled. You can begin saving now. There is no need to wait for a renewal date.

Let us help you take back control!

- Save up to 60% from Occurrence Premiums.
- 3-year rate guarantee.
- Protect yourself from future assessments.

We at BH&L know that your long-term success is greatly increased by proactively managing risk. It's time for a change!

To find out if you're eligible call:
Brian Hurley, CLCS,
Risk Management Specialist
1-800-268-1830 or (315) 413-4407
bhurley@blhinsurance.com

BH&L Bailey, Haskell & LaLonde

5232 Witz Drive
N. Syracuse, NY 13212
www.bhlinsurance.com

SEE OUR ARTICLE ON PAGE 19 FOR MORE INFO.

corporation (again using the "check-the-box regulations). The net income is taxed to the practitioners in accordance with their respective interests in the entity. The entity files an information return that reports the income and expenses of the group and specifies the amount to be taken into account by the members of the group on their individual tax returns, but the partnership itself pays no tax. The income is includable by the members whether actually received by them or not, although later distributions may be tax free.

Corporation

The formation of a corporation by a sole practitioner or practice group is governed by state law. The tax consequences of corporate practice flow from the choice to be either a C corporation or an S corporation.

A C corporation is subject to tax on its net income. Any distributions to the shareholders, other than in the form of compensation, permissible expense reimbursements or the furnishing of benefits that further the business of the corporation, are treated as dividends, which are taxed at the shareholder level. For example, assume that a corporation has a net income of $100,000 and is subject to a tax of 30% on that income. Assume, further, that it distributes all of its after-tax income ($70,000) to its shareholders and that the shareholders are also subject to a 30% rate of tax. The original $100,000 earned by the corporation will end up as $49,000 in the hands of the shareholders.

One provision of the code that is often overlooked suggests that a professional corporation should not be a C corporation. Generally, a C corporation pays tax based on a graduated rate structure that runs from 15% to 35%. However, a C corporation that is a personal service corporation (one in which the principal activity of the corporation is the performance of services by employee-owners) is taxed at the rate of 35% on all of its net income. Because the owners of professional corporations must be the professionals performing the services, inevitably a professional corporation will be treated as a personal service corporation and taxed accordingly.

Avoiding personal service corporation status is simple. Have the corporation elect to be an S corporation with the consent of all of the shareholders (who must be U.S. citizens or resident aliens). With certain exceptions generally not relevant in a professional setting, the S corporation does not pay any tax on its income. The shareholders are in much the same position as members of a partnership or multimember limited liability company. They report their proportionate shares of the income on their individual tax returns even if not paid out to them during the year. Later distributions of previously taxed income are received without any additional tax being due. Therefore, unlike the C corporation, there is only one tax imposed on the income earned by an S corporation.

One aspect of S corporation status affects 2% or more shareholder-employees of the corporation. Although they are employees of the corporation for employment tax purposes (discussed below), they are treated as partners and not as employees when it comes to fringe benefits. For example, the Internal Revenue Code permits an employee to exclude from income premiums on employer-provided health insurance or contributions made to health savings accounts (HSAs). If the employer is an S corporation and the covered employee owns more than 2% of the stock of the corporation, the premiums paid by the corporation for the coverage become compensation income for the shareholder-employee. However, in most cases, this additional compensation is not considered compensation on which self-employment taxes must be paid.

RMS Healthcare
Research & Marketing Strategies
Improving Bottom Line Performance through Superior Marketing Intelligence and Strategic Direction Consulting
Check us out...
www.RMSresults.com
45 Oswego Street, Suite 300
Baldwinsville, New York 13027
Phone: (315) 635-9802
Fax: (315) 720-1159

EMPLOYMENT TAXES

Employees are subject to a 6.2% Social Security tax for the first $97,500 of compensation paid in 2007, and an additional Medicare tax of 1.45% on all compensation; there is no limit on the amount of compensation subject to the Medicare tax. Employers pay the same amount on behalf of their employees.

Self-employed individuals (sole proprietors, members of limited liability companies and partners) pay a combined rate of 15.3% on their earnings from self-employment. Although the 12.4% tax is limited to the first $97,500 of earnings in 1997, the 2.9% Medicare tax applies to all self-employment earnings. This has led a number of practitioners to replace unincorporated forms of doing business (limited liability companies or limited liability partnerships) with S corporations, and to pay themselves salaries limited to the amount subject to the Social Security tax. Of course, the balance of profits earned by the S corporation is still taxable to its shareholders, but the Medicare tax is eliminated.

Consider the following example:

Dr. A, a sole practitioner, practices as the sole member of a limited liability company. If Dr. A's net income for 2007 from the practice is $400,000, Dr. A will be liable for Social Security taxes of $12,090 and Medicare taxes of $11,600, or a total of $23,690.

If, in 2007, Dr. A had practiced as an S corporation and limited his compensation to $97,500, he would have paid $6,045 in Social Security taxes and $1,414 in Medicare taxes. The corporation would have paid a like amount, making a total of $14,918 due from employee and employer, a savings of almost $9,000.

Some S corporation shareholder-employees have sought to reduce the impact of employment taxes further by severely limiting their stated compensation and claiming any additional distributions as dividends from the S corporation. The Internal Revenue Service has been successful in recharacterizing distributions to S corporation shareholder-employees as compensation rather than dividends where the compensation is low for those persons compared to others in similar positions.

Mr. Fried's practice includes personal, corporate, real estate and estate taxation. He is the author of Taxation of Securities Transactions, *a two-volume publication that is supplemented and revised semiannually, and numerous articles on taxation and trusts and estates. Mr. Fried is the Crandall Melvin Professor of Wills and Trusts Emeritus at Syracuse University College of Law, where he taught for 39 years. Mr. Fried has also taught at the University of Iowa, University of Cincinnati and Washington University. He is a member of the American Law Institute's Members Consultative Group for the Restatement (Third) of Property: Wills and Other Donative Transfers and for the Restatement (Third) of Trusts. Mr. Fried is admitted to practice in New York State: U.S. District Court (SDNY and EDNY), The U.S. Court of Appeals (Second Circuit) and U.S. Tax Court. He can be reached at (315) 471-3151.* ■

M.D. NEWS

2008 EDITORIAL CALENDAR

Each month, M.D. News' Editor-in-Chief creates themed features that focus on the most important topics of interest to our targeted professional readers. While advertising in every issue of M.D. News will increase the awareness of your company, you can achieve maximum impact by marketing your products and services in the issues with the most relevant editorial content. Contact your local M.D. News publisher today to discover how you can make your advertising work smarter to influence the buying power of our readers.

EDITORIAL DEPARTMENTS

News: The latest news in medicine, including clinical trial data, legislation and trends in the healthcare arena.

Current Topics: A deeper look into current issues and trends that affect physicians and their practices.

Ethics: Facing the ethical issues physicians face as they practice medicine in the coming year.

Finance: Expert advice on investments and legal issues that face physicians in the legal arena.

The Good Life: Award-winning columnist and author, Natalie MacLean, shares her thoughts on the wonders of the vine.

Adventure Sports: Look here for ideas and information on the latest and greatest sports that will test your mettle and get you as far away from the office as you'd like to go.

CLINICAL FEATURES

JANUARY/FEBRUARY
Obesity

MARCH/APRIL
Prostate Cancer

MAY/JUNE
Preventing and Treating Women's Cancers

JULY/AUGUST
Technology Update: Medical Devices

SEPTEMBER/OCTOBER
Pain Management

NOVEMBER/DECEMBER
New Car Preview

JANUARY
Digestive Disorders
In this primer on digestive disorders, we will look at diseases ranging from heartburn and ulcers to inflammatory bowel diseases such as Crohn's disease.

FEBRUARY
Cardiology
A succinct and up-to-date presentation of the latest research and clinical data in the field of cardiology.

MARCH
Men's Health
An in-depth look at the diseases and medical issues that affect men and those who care for them.

APRIL
Orthopedic Advances
Surgical advances in technology and technique have made orthopedics and orthopedic surgeries more effective and less debilitating for patients.

MAY
Women's Health
An in-depth look at some of the diseases and medical issues that affect women.

JUNE
Allergy
New and old treatments for allergies, both adult and pediatric, including a focus on food allergies.

JULY
Updates in Imaging Technologies
A well-rounded review of some of the many recent advances in imaging technologies, with a look to future research.

AUGUST
Pediatric Medicine
An in-depth look at the issues and concerns of pediatric physicians, parents and the youngest of patients.

SEPTEMBER
Neurology
A review of the many forms of neurologic illnesses, including Parkinson's Disease and epilepsy, as well as their many manifestations and treatments.

OCTOBER
Cancer Update
An update on new options in cancer treatment and prevention, including the latest in cancer detection.

NOVEMBER
Geriatric Medicine
A look at the issues, concerns and diseases that affect the elderly and their caregivers.

DECEMBER
Sleep Disorders
A glimpse into the complexities and new approaches to the diagnosis and treatment of sleep disorders.

For more information about M.D. News magazine, please visit us at mdnews.com