Choosing the RIGHT Practice Entity

How you structure your practice can have big consequences when it comes to liability and taxes.

JEFFREY B. SANSWEET, JD

Perhaps you are starting your own practice, purchasing an established practice or merging your practice with another group. Or perhaps you are simply interested in converting your current practice into a different legal structure. No matter which of these situations applies to you, the entity you choose for your practice will have important implications.

Practice entities typically include sole proprietorships, general partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs) and professional corporations (PCs), which can be either C corporations or S corporations. When choosing a practice entity, the two main factors to consider are liability protection and financial implications.

Protecting yourself

Physicians looking at practice entity options should make certain they understand the degree to which they may be liable for malpractice or creditor problems that occur within the practice. Limiting your liability exposure is a laudable goal, but keep in mind that you cannot limit

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your personal liability for your own professional negligence or malpractice by operating as a particular type of entity. However, operating as a PC, LLP or LLC generally can protect you against personal liability for malpractice committed by another physician in the practice. (General partnerships do not offer this protection, while sole proprietorships do not need this protection.) Additionally, if you are a shareholder of a PC or member of an LLC, you will generally not be held personally liable for claims against the practice.

In matters of financial liability involving creditors, the distinction between an LLC and an LLP is also important. An LLP will generally not protect members against creditors of the LLP itself, whereas members of an LLC are generally liable only to the extent of their investment in the company. For these reasons, group practices often prefer PCs, which provide for complete protection against financial creditors other than the IRS, or LLCs.

Untangling the taxes

The other major factor to consider when choosing a practice entity is how it will be taxed. From a federal income tax standpoint, a PC is a separate taxpayer. If a PC chooses to become a C corporation, which is usually the default, it will be subject to a flat 35-percent tax rate on all net income. On the other hand, sole proprietorships, general partnerships, LLCs and LLPs are generally not separate taxpaying entities. Instead, their net income is passed to the owners, partners or members and not taxed to the practice. If a PC chooses to become an S corporation, the net income passes to the shareholders much like a partnership or LLC.

Many practices operate as C corporations for a number of reasons. In some cases, the state may not have offered LLCs or LLPs as alternatives when the entity was formed.

About the Author

Jeffrey Sansweet is a health care attorney with Kalogredis, Sansweet, Dearden and Burke, Ltd. in Wayne, Pa. Conflicts of interest: none reported.

Additionally, some practices chose C corporations because at one time they could offer more favorable retirement plans than S corporations, though this is no longer the case. Also, certain fringe benefits such as health insurance used to be fully deductible only to C corporations, but the tax treatments have since been equalized. As a result of these changes, the S corporation is now more popular.

Because a C corporation is subject to the 35-percent flat tax on net income, the practice must have little or no profit at the end of each fiscal year by paying out bonuses. However, upon an IRS audit, some of the compensation paid to the shareholders may be deemed unreasonable and thus a nondeductible dividend if the compensation resulted from the efforts of a non-owner physician, nurse practitioner or physician's assistant. This would result in a 35-percent tax on the compensation in question, plus interest and penalties. Also, when a C corporation sells its practice, it must avoid double taxation. The gain on the sale of the assets will produce tax at the 35-percent level, and the proceeds distributed to the shareholders will be taxed to them individually.

With an S corporation (and also a sole proprietorship, partnership, LLC or LLP), there is no risk of a double tax on an annual basis or upon the sale of the practice. There is also an opportunity to save on FICA self-employment taxes because an S corporation can pay the shareholders pro rata distributions in lieu of a salary or bonus. However, the distribution should be limited to a small percentage (perhaps no more than 10 percent) of the salary to avoid IRS scrutiny.

Weighing your options

Before your practice decides to convert your existing C corporation to an S corporation or your partnership to an LLC or PC, make sure you are aware of a few important points. The conversion from a C corporation to an S corporation may cause a significant "built-in gains" tax on the value of goodwill and accounts receivable. Also keep in mind that

Operating as a PC, LLP or LLC can provide liability protection for you if a physician in your practice commits malpractice.

PCs will protect shareholders from financial creditors other than the IRS.

Certain practice entities such as sole proprietorships, general partnerships, LLCs and LLPs are not separate taxpaying entities.

S corporations and C corporations both offer favorable retirement plans and fully deductible benefits, such as health insurance.

To avoid a 35-percent flat tax on net income at the end of the fiscal year, C corporations should pay out bonuses to shareholders.

Be aware of the requirements and restrictions for each entity before you make your choice.

an S corporation is limited to 75 shareholders. In addition, the conversion from a partnership to an LLC or PC will require obtaining a new Employer Identification Number from the IRS, which would then necessitate an application for a new Medicare assignment account, which could delay your practice's claims processing for many months.

State taxes should be factored into your decision as well. For example, in Pennsylvania there is a "capital stock tax" that applies to C corporations, S corporations and LLCs. In Pennsylvania there is also an annual registration fee of approximately $350 per member for a professional LLC and approximately $250 per partner for an LLP.

Finally, there are operational and financial factors that come into play. Sole proprietors, LLCs, LLPs and general partnerships typically pay the owner, members or partners a "draw," and, in turn, the physician(s) must pay estimated state and federal taxes throughout the year. The cash draw never exactly matches the taxable income. With a PC (either an S or C corporation), the physician generally receives a paycheck with taxes withheld. Many physicians prefer the latter.

The costs to set up and maintain the practice entity can vary from state to state, but typically a PC is a bit more expensive. PCs also require a record of annual minutes, bylaws, a buy-sell or shareholder agreement, and employment agreements. A general partnership or LLP only requires a partnership agreement, while an LLC requires an operating agreement.

Choose wisely

Physicians have a variety of entity choices for their practices with several distinctions to remember. Each practice situation is unique, and a physician or group should consult with a qualified attorney and accountant before making the decision. Although I usually recommend an S corporation for a new group and a sole proprietorship for a physician who does not anticipate practicing with another physician, take the time to evaluate the pros and cons of each type of entity. You will find the one that's right for you. FPM

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PRACTICE ENTITIES AT A GLANCE

	Sole proprietorship	General partnership	Limited liability company (LLC)	Limited liability partnership (LLP)	Professional corporation (C corporation)	Professional corporation (S corporation)
Provides personal liability protection from one's own negligence	No	No	No	No	No	No
Provides personal liability protection from a partner's negligence	N/A	No	Yes	Yes	Yes	Yes
Provides personal liability protection from claims against the practice	No	No	Yes	No	Yes	Yes
Provides personal liability protection from creditors	No	No	Yes, except to the extent of one's investment in the LLC	No	Yes	Yes
Taxation rules	Net income passed through to owner	Net income passed through to partners	Net income passed through to members	Net income passed through to partners	35-percent tax on net income	Net income passed through to shareholders