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Choice of Entity for Law Firms: One Size Doesn't Fit All

For generations, law firms formed as partnerships, at times for no reason other than tradition. The advent of professional corporations more than 30 years ago, however, gave firms new choices. When electing an entity form, firms must be aware of tax implications and limitations imposed by state laws.

Types of Entities

Most law firms opt for one of four common entity types.

C corporations. A C corporation is the only entity type discussed here that pays entity-level taxes.

C corporations must pay taxes on any undistributed revenue, and, because the rules of a personal service corporation apply, that revenue is taxed at a high corporate rate. To avoid these taxes, law firm C corporations generally distribute payroll bonuses at the end of the year, thus eliminating taxable profits.

The bonus process may be a hassle, but C corporation law firms find it worth enduring to reap certain tax advantages related to fringe benefits. C corporations are also permitted to make larger contributions to profit-sharing plans.

S corporations. Unlike its corporate counterpart, an S corporation doesn't pay taxes. Instead, any "leftover" profits are reported using Schedule K-1, with a schedule filed for every owner; each individual owner is then taxed on a personal basis. For purposes of Schedule K-1s, profits are distributed to the owners based on their percentage of ownership, rather than performance or other factors.

While an S corporation doesn't need to engage in the year-end bonus process for tax purposes, it will likely distribute bonuses anyway to take into account factors beyond ownership share.

Partnerships. Unlike corporate entities, the owners in a partnership are not paid as employees, with salaries. Rather, they typically receive a draw against their shares of ownership. The Schedule K-1 is used to allocate profits to the partners, usually based on performance, and the partners pay personal taxes on those sums.

Some drawbacks are associated with partnerships. The primary drawback is the joint liability that a partnership creates, making every partner vulnerable to the wrongs of one. Further, any profits that remain after the Schedule K-1 allocation will be distributed on an economic basis, often based on ownership.

Limited liability companies. In recent years, more and more firms have opted for LLC status. An LLC can elect to be taxed as a partnership or a corporation. Most elect the former, which also serves as the default in the absence of an explicit election otherwise. An LLC law firm is then allowed to distribute its profits as a partnership would (and, in fact, is granted greater flexibility in the allocation of profits), without comparable liability exposure.

State Law Limitations

Of course, in making entity decisions, firms need to carefully consider how their respective states tax each type of entity. Some states do not recognize S corps, partnerships, or LLCs, so these entities will be subject to state corporate taxes.

Individual attorneys should also be wary of the possibility of double taxation if they live in a different state than they work, and the two states apply conflicting rules.