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Considerations in Starting a Medical Practice: Part II: Choosing Your Form of Business Entity

By: Anne Cornelius, CPA

Starting a medical practice requires careful planning and consideration of all aspects in forming and running your own business. In a previous article we addressed the issues surrounding the decision to open your own practice and the selection of your team of experts, such as your Certified Public Accountant and practice management consultant (see “Considerations in Starting a Medical Practice- Part I: Forming Your Team of Experts,” January 2000 issue of Round-up). Of equal importance is your decision regarding the type of business entity appropriate for your needs.

As a precursor to considering the appropriate form of entity, you’ll need to make a decision whether to practice solo or with a group. As a solo physician, you reap all of the profits associated with your own labor and have all the independence to make all of your own decisions regarding the operation of your practice. Some disadvantages may include loss of ability to consult with other physicians in your group, and less freedom for leisure activities and vacations. Typically, the capacity of your own solo practice to generate income is directly related to the time and effort that you, alone, put in to providing services. Other factors to be considered would include your own personality, your area of specialization, and the geographical environment in which you plan to practice.

Choosing a form of entity is no task to be taken lightly and you’ll want to seek the guidance of your Certified Public Accountant.

The tax and legal liability ramifications can be great. It is vitally important to consider the various forms of business organization and choose the form of entity best suited to the nature of your practice. Consideration must be given to tax treatment, available benefits and liability issues.

Sole Proprietorship

A sole proprietorship is the simplest form of business entity. You would individually own your own medical practice. One of the advantages is that there is virtually no government cost or formality to forming or maintaining a sole proprietorship.

Your net profit or loss (regardless of the amount you took in draws) is reported on your individual income tax return. The effect of this is that the net income of your medical practice is taxed at your individual tax rate. It is important to note that you cannot deduct for tax purposes, the cost of your own benefits such as disability insurance, sick pay plans, medical expense reimbursement plans, group insurance plans, etc., as a corporation can. You can, however, deduct such costs for benefits to your staff members, and you can deduct a limited percentage of your own medical insurance premiums on your personal tax return (60% for year 2000).

In addition to regular income taxes, your practice net income is subject to self-employment taxes on the Federal level. Self-employment

taxes are your contribution to the Social Security system and are assessed on your individual tax return.

As a sole proprietor you will have unlimited liability for the debts and liabilities of the business. In other words, all of your personal assets are at risk for the claims of business creditors. As a practical matter, the only way for sole proprietors to protect their personal assets is through insurance. There are various types of insurance that can protect a medical practice from loss of income following fire, storm and other natural disasters, theft by employees or patients, loss of services from key employees, general liability and others. Your professional liability insurance will offer protection from claims of malpractice. No insurance is available to protect against bad business decisions, effects of competition and general business or entrepreneurial risk.

Because of the increased liability risk associated with operating as a sole proprietorship, your CPA and attorney are not likely to recommend this form of entity unless you will have no employees, as is the case for most hospital-based physicians.

Partnership

A partnership is an association of two or more persons or entities to carry on as co-owners of a business for profit. A partnership agreement is necessary to create a partnership. Although not required to be in writing, a written partnership agreement is recommended. There are no documents to be filed with any governmental agency, no filing fees, and no formalities to the formation of a partnership.

Partnerships are a pass-through type of business entity. That is to say, their net income or loss is passed through to you and your partners on a pro rate basis for assessment of tax on your individual income tax returns.

The partnership is not taxed as an entity and files only an “informational tax return”. As with the Sole Proprietorship, the deductibility of the benefits to you and your partners, such as group insurance, medical reimbursement plans, and disability insurance are limited. The advantages of this form of entity lie in the ability to specifically allocate, within certain limits, items of income or loss to a specific partner or partner group.

You and your partners have unlimited liability for the debts and liabilities of the business. You are jointly and severally liable for the debts and liabilities of the partnership. As with a sole proprietorship, the only way for you to protect your personal assets is through insurance. A relatively new form of entity, the Limited Liability Company discussed later in this article, has virtually eliminated any incentive for forming a partnership because it offers protection from claims against your personal assets in many cases, while still allowing the basic structure of a partnership.

C Corporation

You can form a corporation with one or more persons or entities, called “incorporators”. Your corporation can exist with one director and two officers (a president and a secretary). However, a single individual may serve as both president and secretary. The formation process is more complex, requiring the articles of incorporation and disclosure statement be filed and approved by the Arizona Corporation Commission. The corporation requires bylaws and minutes of an organizational meeting and must hold at least annual shareholder and director meetings. It must also file a short annual report with the Corporation Commission and pay a small annual fee. The corporate form permits deductibility of benefits for tax purposes. However, corporate income is subject to tax at the corporate level

and again at the shareholder level when dividends are paid or the corporation is dissolved.

The taxation of regular C corporations can be the most complex area of business taxation. Corporations are separate entities and unlike those discussed previously, they are taxed differently. In most cases, a corporation will pay corporate income taxes on its net income. Capital gains are taxable at regular corporate tax rates.

There are numerous opportunities and special considerations in the taxation of corporations owned by physicians.

Several years ago, a change to the federal laws limited the use of the corporate structure with respect to individuals engaged in personal services, i.e. physicians, lawyers, architects, engineers, veterinarians, accountants, consultants, etc. The Internal Revenue Code defines such corporations as Personal Service Corporations. Should you decide to incorporate, your income is taxed at a flat 35% starting with the first dollar of net profits. Proper tax planning can usually eliminate this tax through bonuses and retirement plan contributions.

Ownership interests are only afforded to professionals practicing in the same field. You can form a PSC with other physicians, but you cannot form a PSC with other family members or say, an architect, for example. In addition, you generally must have a calendar year-end. There are special situations in which you may be granted a year-end other than December 31, but doing so requires careful tax planning and you should seek the ongoing advice of your Certified Public Accountant.

As a shareholder, you are granted limited liability by the law. Your personal assets are not subject to claims of business creditors. Nor are you personally liable for certain acts

arising out of the operation of your practice, such as claims of a person injured by a staff member in an auto accident.

Keep in mind, however, that no matter which form of entity you choose, you are always personally liable and responsible for your own acts of malpractice. No form of entity can protect your personal assets when your own due diligence and judgment are in question. Only malpractice insurance can help protect you in the event of a claim. And it is important to note that, although you are not personally liable for corporate debts, it is quite common for lenders to require a personal guarantee from shareholders of a Personal Service Corporation. However, any limited liability can be lost if the creditor is able to “pierce the corporate veil”. This may occur if the court finds that you have disregarded the corporate form and the formalities that the law requires.

S Corporation

This type of corporation is virtually the same as a C Corporation under state law. It provides you and the other shareholders with limited liability. If your corporation qualifies as a small business corporation under the Internal Revenue Code, you may elect Subchapter S Corporation Status, i.e., its profits and losses are passed through to you and any other shareholders. Requirements for S Corporation status include the following:

- The corporation cannot have more than 75 shareholders.
- The shareholders must be individuals, estates, or certain trusts or charitable organizations (not other corporations or partnerships, etc.)
- The corporation must have only one class of stock.

The S corporation form of ownership may be useful if your practice is expected to sustain losses to pass through as a deduction against your other income. S corporations are also desirable when seeking to avoid double tax or tax at what could be a higher corporate tax rate.

The net income of an S Corporation is allocated to you and the other shareholders in proportion to your ownership percentages. There are numerous special deductions and income items that are not included in the net income of an S Corp. and are passed along (separately stated) to the shareholders. These include interest income, Section 179 depreciation, charitable contributions and medical insurance premiums. The net effect of all of this is that the income and adjustments of an S Corporation are taxed to you at your individual tax rate.

Limited Liability Company (“LLC”)

This is a relatively new form of entity now permitted under Arizona law. Although all states now have an LLC statute, each one is different. However, we will address the LLC as it pertains to Arizona’s Statute.

This form of entity requires one or more members. However, an LLC with only one member is treated as a sole proprietorship unless it elects to be taxed as a corporation. The members of the LLC should execute an operating agreement, which is the equivalent of a shareholder agreement or partnership agreement. It should set forth the interests of its members, management authority, terms for continuing the business if a member leaves and procedures for operating the firm. You’ll need to take care in drafting the articles of organization and operating agreement, so that the IRS does not reclassify it as a corporation for tax purposes.

If you form an LLC, you and the other members are granted limited liability by the law. As with a corporation, your personal assets are not subject to claims of business creditors or for certain liabilities arising out of the operation of your practice. But again, this limited liability can be lost if the creditor is able to “pierce the corporate veil”. This may occur if the court finds that you and the other members have disregarded the LLC form and the formalities that the law requires. It is very important to pay careful attention to the formalities of the LLC structure or risk a court opening personal assets of the members to claims of business creditors.

Limited Liability Companies are usually taxed the same as partnerships. Net income or loss is passed through to you and the other members. The reporting requirements are usually identical to those of the partnership, and benefits paid for by the LLC are included in the member’s income for tax purposes. An LLC is especially attractive when it has the ability to be treated as a partnership. You are afforded much greater flexibility with respect to allocation of profits and losses among the LLC members. For this reason, most LLC’s are formed when a partnership would otherwise be the chosen form of entity.

The Arizona Limited Liability Company Act permits the use of a professional limited liability company (PLLC). As with a Personal Service Corporation, membership interests are only available to other physicians in a medical practice. The use of PLLC status does not change the legal relationship between you your patient. You will remain personally reliable for your own professional activities and those of any person under your direct supervision. However you generally are not responsible for the liabilities arising from the professional activities of the other physician members. This section of the Arizona LLC Act makes the Limited Liability Company an attractive

option for Arizona physicians considering practice as a group.

As previously indicated, formation of a corporation or an LLC requires more in the way of formal documentation and procedures. Following is a listing of the basic steps to incorporating a business. Organizing an LLC requires similar steps.

Procedures for Incorporating in Arizona

- Reserve chosen corporate name. In cases where a name is available but follow-up with actual incorporation is not expected to take place within an early time frame, it is best to reserve the name. You will be able to reserve the desired name for 120 days.
- File Articles of Incorporation, Certificate of Disclosure and Statutory Agent Acceptance of Appointment with the Arizona Corporate Commission.
- Publish Articles of Incorporation within the time period specified by the Commission.
- Apply for a Federal EIN(Employer Identifying Number) from IRS.
- Apply for an Arizona withholding tax number and if necessary, a Transaction Privilege Tax number. Apply for workers' compensation insurance.
- Prepare Bylaws, sample stock certificate and other miscellaneous legal documents.
- Conduct an organizational meeting. Elect your officers and directors and designate your incorporators. Document "In lieu of..." meeting minutes for corporate records. Adopt bylaws.

- Issue stock, and record in stock ledger.
- Prepare bill of sale or stock exchange documents for any major assets to be brought into the Corporation.
- Prepare Depository Designation document for selected bank to be used.
- Prepare policies if any were adopted.
- Set up corporate bank account. Do not use the account for anything other than corporate transactions.
- If appropriate, apply for a Subchapter-S election with the IRS.
- Optional: Order a corporate embosser from an office supply house. All corporate documents would be impressed with this seal if used.

Choosing your form of entity is a critical part of the decisions you'll make in opening a new medical practice. Each entity has its own liability concerns, tax planning implications, and special characteristics making one or another form of entity more appropriate for you and your colleagues. Be sure to consult your Certified Public Accountant during the decision-making stage.