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How-to content on just about any topic a legal professional needs to know

Choosing a Limited Liability Entity: Which Form is Best for Your Law Firm?

A lawyer or group of lawyers may limit legal liability and minimize income-tax and payroll-tax costs by doing business as a limited liability entity. Here is some basic information on choosing the most appropriate entity for your practice.

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VIDEO Joe Boucher explains why you should consider forming your law firm as a limited liability entity.

Perhaps because of the downturn in the economy or cutbacks in hiring by law firms, Practice411™, the State Bar of Wisconsin's Law Office Management Assistance Program, has received an increase in requests for information from lawyers who are exploring the possibility of going solo or forming small firms. These lawyers often ask which limited liability entity to choose when forming their practices.

Following a Wisconsin Supreme Court Rule (SCR) change in 1997, lawyers and law firms are permitted to limit the legal liability in their law practices by forming their business as a limited liability company (LLC), a limited liability partnership (LLP), or a service corporation (S.C.). SCR 20:5.7(a)(1) provides that a lawyer may be a member of a law firm that is organized as a limited liability organization solely to render professional legal services under the laws of Wisconsin, including Wis. Stat. chapters 178 and 183 and subchapter XIX of Wis. Stat. chapter 180.

Lawyers May Use Limited Liability Entities to Avoid Vicarious Liability

A limited liability entity will not protect the attorney-owner in every instance of liability. Although organizing as a limited liability entity will protect an attorney-owner or employee from the entity's general debts or contractual obligations and from the negligence and misconduct of any other person who is not under the owner or employee's supervision and control, such organization will not shield the lawyer from his or her own acts, errors, and omissions associated with performing his or her professional services. SCR 20:5.7(b).

Although attorneys and firms want to limit their exposure for liability not only for themselves but also for their colleagues, individual attorneys always are legally responsible for their own professional negligence and for the negligence of individuals under the attorney's supervision and control.

Whether an attorney chooses to form a business as an LLP, LLC, or service corporation (and if a service corporation is elected, whether it is taxed as a regular corporation or elects to be taxed as a subchapter S corporation), the determination of which legal entity to use is largely based on the individual attorney's tax situation. Although it is a good idea to consult a CPA for advice concerning the taxability features of a particular entity, the following basic information is also useful.

Individual lawyers can form single-member LLCs. The LLC organizational structure can protect an individual from normal contractual liability and perhaps some personal liability for other people's legal work for which they are not directly responsible. The LLC entity will not, however, protect an individual attorney from liability resulting from his or her own professional negligence or the negligence of individuals under the attorney's supervision and control.

Groups of lawyers can form S.C.s, LLPs, or LLCs. Which entity they ultimately select is primarily a tax choice. The accompanying chart demonstrates the advantages of an S corporation. In an S corporation, the entity may elect to pay a portion of the earnings as dividends for which only income taxes are paid, thus avoiding payroll taxes. Payment of a dividend reduces the overall taxes paid by the owners.

While the chart is for a three attorney-owner firm, the tax benefits

of being an S corporation also apply to a single attorney-owner firm. In a multiple attorney-owner firm, an S corporation generally is the best tax choice. This chart does not reflect any fringe-benefit considerations.

If multiple lawyers desire partnership tax treatment and are forming a new entity, LLCs are generally much better than LLPs. The LLP statute is somewhat out of date as compared to the LLC statute. Both provide the same limited liability protection, but the LLC statutes are simply more current.

The Mechanics of Forming a Limited Liability Entity

Under SCR 20:5.7 and State Bar of Wisconsin requirements, lawyers and law firms must annually register limited liability organizations with the State Bar. The registration form must be signed by a lawyer who is licensed to practice law in Wisconsin and who holds an ownership interest in the entity seeking registration. The registration must include 1) the name and address of the limited liability organization being registered; 2) the name of the state or jurisdiction in which the entity is organized if not Wisconsin; 3) the attorneys' names, home addresses, states or jurisdictions where licensed to practice law, attorney registration numbers, and nature of ownership interests (such as partner or shareholder) in the firm; and 4) proof of liability insurance. The registration form, along with the certificate of malpractice insurance, must be submitted to the State Bar of Wisconsin, accompanied by a registration fee of $75 (for the initial registration) or $25 (for subsequent years). The registration is effective July 1 through June 30 of each year. Registration forms are available at www.wisbar.org/formembers/ethics/pages/llc-firm-registration.aspx.

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Limited liability entities must carry professional liability insurance. SCR 20:5.7(bm) sets forth a scale of law-firm minimum-insurance requirements, based on the number of attorneys in the firm, ranging from $100,000 per occurrence/$300,000 in the aggregate for a solo practitioner to $10 million per occurrence/in the aggregate for the largest law firms. Proof of liability insurance must accompany the annual registration submitted to the State Bar

Business Entity Tax Comparisons: C Corp, S Corp, Partnerships/LLCs

Annual Tax Savings by Entity Type for Tax Purposes

- Assumptions: Tax year 2012
- Three equal owners
- Have been in business for several years with steady income
- Anticipate continuing business for several more years
- Personal tax rate is 25%
- Corporate tax rate is 35%
- Social Security tax rate is 7.65% for corporation and for the individual up to $110,100
- Options 1 & 2 assume $100,000 income per owner

	C Corp	s Corp	Partnership/l l C
Option 1: Pay a ll Income to Owners			
Taxable income before owner salaries	$300,000	$300,000	$300,000
Deduction for employer share of SS tax	$21,318	$21,318	$0
Net owners' salaries	$278,682	$278,682	$300,000
Entity net income	$ -	$ -	$ -
Entity taxes	$ -	$ -	$ -
Personal taxes per owner			
Taxable income	$92,894	$92,894	$100,000
Self-employ (SE) tax deduction			$7,064
Net before income taxes	$92,894	$92,894	$92,936
Tax rate	25%	25%	25%
Taxes	$23,224	$23,224	$23,234
SE Tax line 3			$100,000
Factor .9235			$92,350
Total Soc Sec SE taxes	$7,106	$7,106	$12,283
Corporate taxes per owner			
Income taxes	$0	$0	$0
Soc Security	$7,106	$7,106	$0
Total taxes per owner	$37,436	$37,436	$35,517
Total taxes for all owners	$112,307	$112,307	$106,551
Net after tax cash	$187,694	$187,694	$193,449
Net per owner after taxes	$62,565	$62,565	$64,483
Option 2: Max a fter-Tax Income to Owners			
Taxable income before owner salaries	$300,000	$300,000	$300,000
Deduction for employer share of SS tax	$21,318	$14,925	$212,138
Net owners' salaries	$278,682	$195,075	$300,000
Distributions/Dividends		$90,000	
Entity net income	$ -	$ -	$ -
Entity taxes	$ -	$ -	$ -
Personal taxes per owner			
Taxable income	$92,894	$95,025	$100,000
Self-employ tax deduction			$7,064
Net before income taxes	$92,894	$95,025	$92,936
Tax rate	25%	25%	25%
Taxes	$23,224	$23,756	$23,234
SE Tax line 3			$100,000
Factor .9235			$92,350
Total Soc Sec SE taxes	$7,106	$4,974	$12,283
Corporate taxes per owner			
Income taxes	$0	$0	$0
Soc Security	$7,106	$4,974	$0
Total taxes per owner	$37,436	$33,705	$35,517
Total taxes for all owners	$112,307	$101,115	$106,551
Net after tax cash	$187,694	$198,885	$193,449
Net per owner after taxes	$62,565	$66,295	$64,483

and must include the name of the professional liability carrier, the policy's number and expiration date, and the limits of liability and deductible.

Law firms organized as limited liability organizations must include a designation of that limited liability structure as part of their names. This requirement has led to wide varieties of usage. Some firms specifically say they are limited liability entities in addition to using LLC, LLP, or S.C. in their names. Others do not add any reference to the limited liability status other than by using the LLC, LLP, or S.C. designation.

SCR 20:5.7(e) also requires that law firms and attorneys provide a summary notice to clients and potential clients of the features of the law firm's limited liability. Typically, a firm that has limited liability includes this notice in its engagement letter.

More Solos and Firms Should Take Advantage of the Protections Afforded

Despite the benefits of forming as a limited liability entity, the number of lawyers forming entities each year is still relatively small. More than 24,900 lawyers are licensed in Wisconsin. There are approximately 3,900 law firms (2,748 are solo practices consisting of only one lawyer). There are 4,289 limited liability business entities registered with the State Bar (989 S.C.s, 1,953 LLCs, and 1,347 LLPs). We do not know how many LLCs are single-member LLCs. But it is clear that many sole practitioners are not limited liability entities, and that not all law firms are, either. If you're thinking about going solo or forming a firm, you can protect your business by organizing as a limited liability entity. **WL**

What's on your mind? Email your "101" topic ideas to wislawyer@wisbar.org.

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