Inc.

SHOULD A YOUNG LAWYER INCORPORATE?

—**Robert Parker**

Because of certain federal income tax advantages and the possibility of some limited liability, considerable interest in the incorporation of professional practices has existed for a number of years. Many professionals were reluctant to incorporate, however, at least in part because the Internal Revenue Service took the position initially, despite state statutes, that such professional "corporations" were not bona fide corporations and were not entitled to the tax benefits flowing to corporations. Finally, in August, 1969, after many court battles, the Service generally conceded that professionals could incorporate. Since that time, there has been a profusion of professional incorporations, especially among doctors and certain other professional groups. There is still the risk that the Service will scrutinize professional corporations very carefully on audit and the risk that the Service will look unfavorably upon corporations which have only a single stockholder-employee. Such an individual can, under Virginia law, incorporate, but he must operate his practice with a great degree of care.

The paramount federal income tax advantage to incorporation is that an employee-stockholder of a corporation can currently take advantage of more liberal pension and/or profit-sharing benefits than can an owner-employee (i.e., a sole proprietor or partner for purposes of this article).

Generally, a qualified pension and/or profit-sharing plan permits an employee to receive a deferred benefit in lieu of current cash compensation which would be taxable as ordinary income. The business can set aside an amount in a trust, for which it will still be entitled to a current deduction as though it had paid compensation, but for which the employee will report no current income. The trust will invest the funds, but will pay no income tax on its income. Generally, the employee must include distributions from the trust in his income as ordinary income at the time such distributions are made in later, retirement years when his taxable income and tax rate will presumably be lower.

The following example will illustrate the advantage of a qualified pension or profit-sharing plan in general. Assume A is an individual who is in the 32% federal income tax bracket. Assume further than A's taxable income (after all exemptions and deductions) is approximately $22,000. A will pay a tax of 32% on his top $2,000 of income or $640. Thus, if $2,000 is paid to him as currently taxable compensation, he will have $1,360 of his top $2,000 to invest in future years. Assume that his investments will yield 10% per year or $136 before taxes. That return will also be taxable at his increasing tax rate or, at best, at one half that rate as long-term capital gains. If that return is taxed on an average rate of 40%, A's after-tax return will be $82 per year (60% × $136). In thirty years, A would have a total of $3,820 [$1,360 plus (30 × $82)] to account for his initial $2,000 compensation. If instead of paying $2,000 to A as compensation, his employer paid the $2,000 into a qualified pension or profit-sharing trust, the full $2,000 could be invested and the return on such investment would not be taxable until distributed to A at a later date. Assuming the same 10% return over a thirty year period, the $2,000 fund would earn $6,000 (30 × $200). Thus, at the end of thirty years there would be $8,000 in the fund. Assuming that tax rates will remain fairly constant and that A will be able to withdraw the funds from the trust at about a 25% rate in retirement years when he will have a very little earned income, the tax on the $8,000 will be $2,000. Thus, A will have $6,000 to account for the original $2,000 of compensation, compared to $3,820 if payments had been made to him currently. Increase this difference to reflect A's financial ability to put more and more into the pension and/or profit-sharing plan and multiply the difference by the number of years for which payments will be made to the plan, and the tremendous lifetime advantages of such a plan become apparent.

The benefits of a qualified pension or profit-sharing plan are available to an owner-employee, but a corporate employee-stockholder can shelter much more in such a plan than can an owner-employee. No more than 10% of earned income or $2,500, whichever is less, can be put into an owner-employee's trust fund in any given year and taken as a tax deduction. On the other hand, up to 25% of the compensation otherwise paid a corporate employee can be put into qualified pension and profit-sharing plans on his behalf. There are also other differences between the treatment of qualified owner-employee plans and qualified corporate plans which strongly favor corporate plans. The ability to shelter more money is, however, the single most important difference and the one which influences so many professionals to incorporate.

Obviously this difference is not particularly important to a young lawyer just beginning his practice. He will be lucky if he can afford to put 10% of his compensation into a qualified trust fund (which 10% will most certainly be less than the maximum $2,500). Thus, a young lawyer would incorporate because of hoped-for, and not present, pension and/or profit sharing plan advantages. It is far from clear, however, that such a distinction will even exist in the near future. Congress is presently considering a bill submitted by the Administration which will allow an owner-employee to contribute up to 15% or $7,500, whichever is less, to such a qualified trust fund. In addition, the difference in treatment between owner-employees and corporate employees is constantly under general scrutiny. Thus, even if the Administration bill does not pass, another might well become law prior to the time a young lawyer could benefit from the substantial differences. It is doubtful, however, that there will be equality for owner-employees and corporate employees in the near future. The tax law in this area will probably continue to favor corporations to some extent.

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A reader might be wondering by now how he would avoid a double tax on the income not put into a pension and/or profit-sharing plan (the corporate tax on income plus the individual tax on any amounts paid to him). The answer has been simple in the past—all of a professional corporation's income was considered to be from services; therefore, it was reasonable for a professional corporation to pay out nearly all of its income to its professional employees as set salaries or as year-end bonuses. Presently, however, the Economic Stabilization Program may prevent the corporation from increasing salaries or paying bonuses to a sufficient extent to absorb all of the income from the corporation. In addition, a recent line of cases has held that the capital of a corporation is an income producing factor, and that some of a corporation's income is necessarily attributable to such capital and not to the services performed by the corporation's employees. The corporation would be taxed at the rate of 22% on the first $25,000 of such income each year. The corporation could retain the balance after taxes, or it could distribute such amount as a dividend which would be taxed again to the recipient. In the case of lawyers, this would probably not be a material consideration since the capital investment would not be substantial. There would be some capital (library, furniture, equipment and the like), however, and, under this line of cases, some income should be retained in the corporation. In the past, most lawyers have advised their professional clients to allow some income to be taxed to the corporation in any event in order to give the corporation more substance. It would seem that a relatively insignificant retention by the corporation should satisfy both the capital return and the substance requirements. The cases have indicated, however, that a return on capital in the range of 15% of pre-tax and pre-compensation income may be required. Obviously, there will be more litigation on this issue. In summary, a young lawyer should be aware that, absent a Subchapter S election, he will be required to have some income taxed to the corporation. The amounts so taxed should not be material assuming the lawyer will not have a substantial capital investment, and assuming that the Economic Stabilization Program will not be long-lasting.

Of course, a young lawyer who incorporates can avoid any corporate tax by having his corporation elect to be taxed essentially as a partnership, but without losing most corporate benefits under Subchapter S (the technical requirements of which will not be discussed in this article). Such an election would cause him to lose the basic advantage of a corporate pension and/or profit-sharing plan which was discussed above. As has been noted, however, that should make little difference in the first several years of incorporation, and the Subchapter S election can be terminated when it is advantageous to do so.

Even at the very beginning, there would be some benefits to incorporating a law practice. First, there are some tax benefits available only to common law employees, which term does not include owner-employees. Primary among such benefits is the ability of a corporation to provide tax-free group-term life insurance and disability, hospital and major medical coverage for all corporate employees, including stockholder-employees. Some protection from personal liability would also be afforded. Most state statutes allow professionals to incorporate only while retaining personal liability; for example, Virginia Code §13.1-547 provides that the professional corporation law shall not be construed so as to alter or affect the liability arising out of professional services. It is generally agreed, however, that a stockholder of a professional corporation is not personally liable for the negligent

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acts of other stockholders not under his immediate control and supervision. (A partner is, of course, personally liable for the negligent business acts of his partner.) Finally, there are two practical reasons for preferring a corporate rather than partnership practice. First, it is much easier to transfer shares in a corporation and thereby transfer an interest in such business than it is to transfer an interests in a partnership. In addition, it might be more comforting to some professionals to have their business carried on in a clearly separate entity such as a corporation.

One consideration can be weighed only by the lawyer himself—the reaction of the public to his corporate status (such status, by the way, must be reflected in the name of his firm). It is difficult to judge whether the public has or will react favorably or unfavorably to such incorporation. Public reaction certainly has had no adverse affect on the incorporation of medical practices. With the advent of so many professional corporations, it is doubtful that the public reaction should be particularly persuasive one way or the other.

Especially if a lawyer has not yet begun his practice and will start a new business, he should consider the relative differences between changing from a corporation to a partnership or from a partnership to a corporation in a later year. Although the issue is not totally settled, a partnership, at the present time, can transfer all of its assets, including accounts receivable (for which no income would have been recognized by a cash basis partnership) to a corporation without the recognition of any gain or loss. A corporation, on the other hand, would probably be unable to transfer its accounts receivable without first recognizing income. To the extent of any appreciation in value, a stockholder would also probably have capital gain upon the distribution of other assets in a complete liquidation of a corporation. Although there are some unresolved questions in this area, it can probably be said that it is easier to incorporate a partnership than to liquidate a corporation and form a partnership.

In summary, for those who can take advantage of substantial contributions to pension and/or profit-sharing plans, incorporation at the present time is clearly advisable. On the other hand, for those who cannot make substantial contributions and who will not be able to do so in the very near future (as will be the case with most young lawyers), the decision of whether or not to incorporate is a difficult one. On balance, there may be a slight advantage to incorporating presently and electing to be taxed under Subchapter S until such election becomes unfavorable from a tax standpoint since there are some advantages which can be enjoyed presently, and other advantages which can be enjoyed in the future unless the law is changed considerably. Especially where a young lawyer will be beginning a new practice, incorporation might be advisable because of the present benefits, the hoped-for future benefits, and the likelihood that a future change of entity would otherwise be desired. ■