# BEST ENTITY CHOICE FOR YOU

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## SECTION 1: INTRODUCTION

This presentation is a survey of choices of professional entities and a comparison of the consequences in the state of Washington. This presentation should be viewed only as a decisional starting point to provide an analytic framework based on Washington statutes and federal tax laws. Finally, the presentation covers what factors you should incorporate in your decision-making process.

## SECTION 2: ENTITY CHOICES

In the state of Washington, you have 12 entity choices to select from, as follows:

1. Sole Proprietorship: No specific RCW
2. General Partnership: RCW 25.05.055
3. Limited Partnership: RCW Chapter 25.10 and RCW 25.10.190 Liability
4. Limited Liability Partnership: RCW 25.05.500
5. (Professional) Limited Liability Partnership: RCW 25.05.510 and RCW 25.05.125(4)
6. Massachusetts Business Trust: RCW Chapter 23.90
7. Limited Liability Company: RCW Chapter 25.15 and RCW 25.15.125 - Liability to Third Parties
8. Professional Limited Liability Company: RCW 25.15.045 and RCW 25.15.045(2) - $1M Insurance
9. Personal Service Corporation: IRC* § 448(d)(2)
10. Subchapter C Corporation: RCW Chapter 23B
11. Subchapter S Corporation: IRC § 1361 *et seq.*
12. Professional Service Corporation: RCW Chapter 18.100

*References to "the Code" or "IRC §" are the Internal Revenue Code of 1986, as amended, and are deemed to encompass corresponding provisions of subsequent tax laws.

## SECTION 3: PARTNERSHIPS AND LIMITED LIABILITY PARTNERSHIPS (LIMITED LIABILITY PARTNERSHIPS)

RCW 25.05 *et seq*. provides for both general partnerships and limited liability partnerships in the State of Washington. Limited partnerships are provided for in RCW 25.10 *et seq*. Title 25.05 RCW divides LLPs into three categories: Limited Liability Partnerships (RCW 25.05.500), (Professional) Limited Liability Partnerships (RCW 25.05.510),[1] and Foreign Limited Liability Partnerships (RCW 25.05.550).

### LIMITED LIABILITY PARTNERSHIPS (LLPs)

Generally, the LLP is not the entity of initial choice. Usually, the partners of an existing *general* partnership want limited liability without changing the partnership agreement or business operations.

The touchstone of forming an LLP is to limit individual partners' liability incurred while the entity is transacting its business. RCW 25.05.125 provides, in part:

**RCW 25.05.125**

> **Partner's liability.**
>
> (1) Except as otherwise provided in subsections (2), (3), and (4) of this section, all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.
>
> (2) A person admitted as a partner into an existing partnership is not personally liable for any partnership obligation incurred before the person's admission as a partner.
>
> (3) Except as otherwise provided in subsection (4) of this section [referring to "professional limited liability partnerships"], *an obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner*. This subsection applies notwithstanding anything inconsistent in the

[1] The Application for Registration must be made on the form provided by the Secretary of State. Use of this specific form is limited to registration of limited liability partnerships.

> partnership agreement that existed, in the case of a limited liability partnership in existence on June 11, 1998, and, in the case of a partnership becoming a limited liability partnership after June 11, 1998, immediately before the vote required to become a limited liability partnership under RCW 25.05.500(1).

The state of Washington allows a partnership to file with the Washington Secretary of State's office as a limited liability partnership to limit the personal liability of the partners for debts, obligations, and liabilities of the partnership, whether arising in tort, contract, or otherwise, while the partnership is registered.

Generally, a partner who is also an employee of the limited liability partnership would be subject to liability *as an employee* under current employment law. It is also not clear whether a partner in an LLP would have limited liability in other states.

RCW 25.05.500 sets forth, in part, the formation and registration requirements for a partnership to become an LLP.

## (PROFESSIONAL) LIMITED LIABILITY PARTNERSHIPS

RCW 25.05.510 authorizes a group of persons licensed to render professional services within the state of Washington to become members of a limited liability partnership:

**RCW 25.05.510**

> **Rendering professional services.**
>
> (1) A person or group of persons licensed or otherwise legally authorized to render professional services, as defined in RCW 18.100.030, within this state may organize and become a member or members of a limited liability partnership under the provisions of this chapter for the purposes of rendering professional service. Nothing in this section prohibits a person duly licensed or otherwise legally authorized to render professional services in any jurisdiction other than this state from becoming a member of a limited liability partnership organized for the purpose of rendering the same professional services. Nothing in this section prohibits a limited liability partnership from rendering professional services outside this state through individuals who are not duly licensed or otherwise legally authorized to render such professional services within this state.
>
> (2)(a) Notwithstanding any other provision of this chapter, health care professionals who are licensed or certified pursuant to chapters 18.06, 18.225, 18.22, 18.25, 18.29, 18.34, 18.35, 18.36A, 18.50, 18.53, 18.55, 18.64, 18.79,

> 18.83, 18.89, 18.108, and 18.138 RCW may join and render their individual professional services through one limited liability partnership and are to be considered, for the purpose of forming a limited liability partnership, as rendering the "same specific professional services" or "same professional services" or similar terms.
>
> (b) Notwithstanding any other provision of this chapter, health care professionals who are licensed pursuant to chapters 18.57 and 18.71 RCW may join and render their individual professional services through one limited liability partnership and are to be considered, for the purpose of forming a limited liability partnership, as rendering the "same specific professional services" or "same professional services" or similar terms.
>
> (c) Formation of a limited liability partnership under this subsection does not restrict the application of the uniform disciplinary act under chapter 18.130 RCW, or any applicable health care professional statutes under Title 18 RCW, including but not limited to restrictions on persons practicing a health profession without being appropriately credentialed and persons practicing beyond the scope of their credential.

RCW 25.05.125(4), which is written in the negative, provides the measure of limited liability accorded to individuals providing professional services in a Professional Limited Liability Partnership (PLLP) (reviewed in detail below) as follows:

> (4) If the partners of a limited liability partnership or a foreign limited liability partnership are required to be licensed to provide professional services as defined in RCW 18.100.030, and the partnership *fails to maintain* for itself and for its members practicing in this state *a policy of professional liability insurance, bond, deposit in trust, bank escrow of cash, bank certificates of deposit, United States treasury obligations, bank letter of credit, insurance company bond, or other evidence of financial responsibility* of a kind designated by rule by the state insurance commissioner and *in the amount of at least one million dollars or such greater amount, not to exceed three million dollars*, as the state insurance commissioner may establish by rule *for a licensed profession or for any specialty within a profession*, taking into account the nature and size of the businesses within the profession or specialty, then the partners shall be personally liable to the extent that, had such insurance, bond, deposit in trust, bank escrow of cash, bank certificates of deposit, United States treasury obligations, bank letter of credit, insurance company bond, or other evidence of responsibility been maintained, it would have covered the liability in question.

There is no requirement in RCW 25.05.510 (as there is in the PLLC statute) that "Professional" be incorporated into the name of an RCW 25.15.510 LLP. I use the term "Professional" to avoid confusion.

## TIP ON CONVERTING A GENERAL PARTNERSHIP TO AN LLP OR PLLP

If your business is a general partnership that is eligible and you decide to convert to LLP status, *be sure* that you do not simply adopt your existing partnership agreement as the LLP's operating agreement. For example, if your partnership agreement has provisions that require a partner with a negative partnership capital account to make up such a deficit, such a provision in your LLP's operating agreement would open a "swinging back door of liability" for partners in your LLP, defeating your primary goal of having a limited liability legal entity.

## TAXATION OF LIMITED LIABILITY PARTNERSHIPS

For federal income tax purposes, sole proprietorships, partnerships, LLPs, and LLCs are treated similarly - though they are different entities for Washington State statutory purposes. For IRC purposes, an LLC is taxed as a partnership, similar to an LLP, which is also taxed as a partnership. There is no federal tax on the LLP entity. Income and expenses are allocated to members or partners, and each pays tax of 10% to 39.6% for 2015 (plus self-employment tax, if applicable) on his or her share of the LLP net profit, whether distributed or not. Income and losses pass through to partners. Restrictions on loss deductibility apply.

## ENTITY SELECTION - DISTINCTION BETWEEN SELF-EMPLOYED AND EMPLOYEE

In an LLC/PLLC/partnership/LLP, an owner (partner/member) is classified as self-employed for payroll tax purposes if he or she works for the partnership-type entity. The partner/member, unless he or she qualifies as an "investor member" within the Prop. Treas. Reg. § 1.1402(a)-2 safe harbor, will always be taxed for self-employment tax purposes.

I want to emphasize that in a corporate entity, the owner (Shareholder) is classified as an employee for payroll tax purposes if he or she works for the corporation.

The Shareholder of a "C" corporation will be taxed as an employee for compensation received and will receive a double-taxed (once at the corporate entity level and again at the individual level) dividend distribution representing corporate profits.

The Shareholder of an "S" corporation will be taxed as an employee (similar to a C corporation), but corporate profits will be paid as a Subchapter S dividend not subject to an additional corporate tax as in the C corporation example. Therefore, an S corporation Shareholder can receive compensation subject to employment taxes and a "pass-thru" dividend not subject to employment taxes.

## NO OWNERSHIP RESTRICTIONS FOR LLP/LLC

IRC § 1361(b) requires that an S corporation cannot have more than 100 stockholders (American Jobs Creation Act of 2004) and that each stockholder must be a natural person who is a resident or citizen of the United States. Family members are considered one shareholder effective for tax years beginning December 31, 2004. There are no restrictions on the number or type of owners in an LP, LLP, or LLC, or C corporation.

A partner in an LLP or LP, or a member in an LLC, is free to place his or her entity interests in a revocable, irrevocable, or testamentary trust. But IRC § 1361(d)(3) requires the electing of a Qualified Subchapter S Trust which restricts the use of a trust strategy.

## COMPENSATION INCLUDING "PROFITS" SUBJECT TO EMPLOYMENT TAXES

As I explained above, in some circumstances, partner-employees of an LLP, or member-employees of an LLC/PLLC, who receive all their compensation subject to employment taxes, may pay more in employment taxes than the shareholder-employee of a C corporation, who receives salary and dividends (dividends taxed at income tax top rate of 20% in 2014), or Subchapter S corporation who receives salary and a "pass-thru" dividend (Subchapter S dividends taxed at ordinary income tax rates). All compensation (earned income) of an LLP or LLC or partner/member is subject to self-employment taxes equal to a combined 15.30%. This disadvantage to LLP and LLC entities is most significant for the partner or member employee who receives earned income of less than $117,000 in 2014.

**CHART A**

**Social Security and Medicare Taxes**

| Maximum income subject to tax | | Tax rates / 2014 maximum tax cost | |
|---|---|---|---|
| | **2014** | **Employer and Employee** | **Self-Employed** |
| Social Security | $117,008 | 6.2%/$7,254 | 12.4%/$14,508 |
| Medicare | No limit | 1.45%/No limit | 2.678%**/No limit |

**The tax rate is 2.9%, but only 92.35% of self-employment income is subject to the Medicare tax.

Source: U.S. Internal Revenue Code

In 2014, total employment taxes on salary of $117,000 equal $17,901 plus income taxes.

## SECTION 4: LIMITED LIABILITY COMPANIES (LLCs) INTRODUCTION AND EXPLANATION

The business trust, frequently called the "Massachusetts" trust is a cross between the joint stock company and the conventional trust with some of the characteristics of each. *See* RCW 23.90.020; RCW 23.90.030. It is a common-law devise invented to give continuity of life and limited liability to the owners of shares in the trust thus providing two of the main advantages of the corporation. Most of the reported cases are dated circa 1925. In ***Thompson v. Schmitt***, 115 Tex. 53, 274 S.W. 554 (1925) Texas classified, a business trust as a general partnership. Organized by a deed or declaration of trust, the title to the property of the trust is in named trustees and their successors, with ultimate control in the trustee. The agreement provides for continuity of life through the use of freely transferable shares, similar to shares of stock, the successors in interest becoming members of the trust. Such trusts have at times been set up without reference to a period during which they are to function, at other times with a definite time stated, as, for example, "for 75 years unless sooner terminated by the vote of 2/3 of the outstanding shares." If "ultimate control" is given to trustees who run the business, the beneficiaries are not liable to creditors of the trust beyond the amount they agreed to contribute. ***Goldwater v. Oltman***, 210 Cal. 408, 292 P. 624, 71 A.L.R. S71 (1930), a case of first impression

in California. The business trust is the "grandfather" of the limited liability company.

## LIMITED LIABILITY COMPANY STATUTORYAUTHORIZATION

Limited liability companies grew from the desire to enjoy the protection of a corporation without all the complex rules that apply to corporate structures. "In a nut shell, the founding idea was to enjoy the tax status and ease of daily operation of a partnership with the legal liability protection unique to corporations."

RCW 25.15.005(4) defines an LLC as follows:

> "Limited liability company" and "domestic limited liability company" means a limited liability company *having one or more members* that is organized and existing under this chapter.

Further definitions in RCW 25.15.005 relevant to this survey are as follows:

> (7) "Manager" or "managers" means, with respect to a limited liability company that has set forth in its certificate of formation that it is to be managed by managers, the person, or persons designated in accordance with RCW 25.15.150(2).
>
> (8) "Member" means a person who has been admitted to a limited liability company as a member as provided in RCW 25.15.115 and who has not been dissociated from the limited liability company.
>
> (9) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.
>
> (10) "Professional limited liability company" means a limited liability company which is organized for the purpose of rendering professional service and whose certificate of formation sets forth that it is a professional limited liability company subject to RCW 25.15.045.
>
> (11) "Professional service" means the same as defined under RCW 18.100.030.

RCW 25.15.050 authorizes limited liability company members to enter into standard-type governance agreements, as follows:

**RCW 25.15.050**

**Member agreements.**

In addition to agreeing among themselves with respect to the provisions of this chapter, the members of a limited liability company or professional limited liability company may agree among themselves to any otherwise lawful provision governing the company which is not in conflict with this chapter. Such agreements include, but are not limited to, buy-sell agreements among the members and agreements relating to expulsion of members.

## PIERCING THE LLC VEIL

The Washington courts will apply the concept of "piercing the corporate veil" (setting aside the liability shield and holding a shareholder personally liable) to limited liability companies and their members in certain abusive situations under RCW 25.15.060.

**RCW 25.15.060**

**Piercing the veil.**

*Members of a limited liability company shall be personally liable for any act, debt, obligation, or liability of the limited liability company to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances.* In this regard, the court may consider the factors and policies set forth in established case law with regard to piercing the corporate veil, except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that the members have personal liability for any act, debt, obligation, or liability of the limited liability company if the certificate of formation and limited liability company agreement do not expressly require the holding of meetings of members or managers.

I want to emphasize that you need to pay particular attention to the last two lines of RCW 25.15.060. You must expressly provide in the certificate of formation and the company operating agreement that the LLC is not required to hold meetings of the member or managers, i.e., failure to observe formalities "shall not be considered a factor tending to establish that the members have personal liability."

## STATUTORY LIMITS OF LIABILITY

An LLC is a form of business organization that combines certain features of a corporation and a partnership. Like a corporation, a properly structured LLC protects its owners (called "members") from personal liability for the debts and obligations of the LLC. When all applicable tax-law requirements are met, however, an LLC is taxed as a partnership instead of as a corporation for federal income tax purposes. In the right circumstances, this combination of limited liability and partnership tax treatment can be highly advantageous to an LLC's owners. RCW 25.15.040(1) provides:

**RCW 25.15.040**

**Limitation of liability and indemnification.**

> (1) The limited liability company agreement may contain provisions not inconsistent with law that:
>
> (a) Eliminate or limit the personal liability of a member or manager to the limited liability company or its members for monetary damages for conduct as a member or manager, provided that such provisions shall not eliminate or limit the liability of a member or manager for acts or omissions that involve intentional misconduct or a knowing violation of law by a member or manager, for conduct of the member or manager, violating RCW 25.15.235, or for any transaction from which the member or manager will personally receive a benefit in money, property, or services to which the member or manager is not legally entitled; or
>
> (b) Indemnify any member or manager from and against any judgments, settlements, penalties, fines, or expenses incurred in a proceeding to which an individual is a party because he or she is, or was, a member or a manager, provided that no such indemnity shall indemnify a member or a manager from or on account of acts or omissions of the member or manager finally adjudged to be intentional misconduct or a knowing violation of law by the member or manager, conduct of the member or manager adjudged to be in violation of RCW 25.15.235, or any transaction with respect to which it was finally adjudged that such member or manager received a benefit in money, property, or services to which such member or manager was not legally entitled.

The liability protection of an LLC appears to be equivalent to that of a corporation in all states where the LLC is recognized. As with a corporation, however, this protection does have limitations of which you should be generally aware.

For example, an LLC generally does not shield its organizers or owners from liability arising from false statements made in the LLC's organizing documents. Similarly, if the business begins operations before the LLC is officially created under state law, the liability shield may be ineffective. For this reason, it is important that those organizing and operating the LLC strictly adhere to all legal formalities right from the start.

Generally, LLC members are not liable on contracts made on behalf of the LLC under RCW 25.15.040. But if a member personally guarantees a loan or other LLC obligation, he or she can be held personally liable for fulfilling the obligation. LLC members may also be liable for their own intentional misconduct or for other personal actions, including professional malpractice, even if these occur while performing services for the LLC.

## INNOCENT SHAREHOLDERS/MEMBERS IN A MULTI-SHAREHOLDER/ MEMBER PROFESSIONAL CORPORATION OR PROFESSIONAL CORPORATION OR PROFESSIONAL LIMITED LIABILITY COMPANY

Is there a difference in liability of innocent shareholders and corporate entity under RCW 18.100.070 compared to the liability of innocent members and the PLLC entity under RCW 25.15.045?

### The Professional Service Corporation

RCW 18.100.070 "Professional Relationship and Liabilities Preserved is the statutory starting point for the analysis of the issue presented. I have divided the statute into three (3) subsections for this analysis:

***FIRST:*** Nothing contained in this chapter (RCW Chapter 18.100) shall be interpreted to abolish, repeal, modify, restrict or limit the law now in effect in this state applicable to the professional relationship and liabilities between the person furnishing the professional services and the person receiving such professional service and the standards for professional conduct.

***SECOND:*** Any director, officer, shareholder, agent or employee or a corporation organized under this chapter shall remain personally and fully liable and accountable for any negligent or wrongful acts or misconduct committed by him or by any person under his direct supervision and control, while rendering professional services on behalf of the corporation to the person for whom such professional services were being rendered.

***THIRD:*** The corporation shall be liable for any negligent or wrongful acts of misconduct committed by any of its directors, officers, shareholders, agents or employees while they are engaged on behalf of the corporation, in the rendering of professional services.

The ***FIRST*** subsection raises the issue of whether innocent shareholders are vicariously liable for professional negligence committed by other lawyer(s) in the Professional Corporation. The precise interpretation of the inclusion or exclusion of the innocent shareholder in the ***FIRST*** subsection is uncertain. There are contradictory opinions regarding the interpretation with regard to the innocent shareholder(s)' liability. Does the phrase in the first subsection "…between the person furnishing the professional services and the person receiving such professional services…," refer only to the professional relationship between individual lawyers rendering services and their clients? If it does, the reference does no more than restate the basic premise that lawyers cannot escape liability for their own malpractice and provides limited liability for innocent shareholder(s). Alternatively, does the phrase in the ***FIRST*** subsection **not include in its reference of** "person furnishing professional services" to the precise lawyer(s) who personally participated in the transaction out of which the liability arose? In the latter case, the innocent shareholder(s) would be vicariously liable.

Analyzing the statute, Professor Boris I. Bittker in 17 Tax L. Rev. 1, 10-11 (1961) questioned the "precise lawyer" interpretation to avoid the application of vicarious liability for professional negligence committed by the innocent shareholder(s) in the firm. His opinion supports the interpretation that innocent shareholders can be vicariously liable to third-party claims.

An analogous area of corporate law arises under RCW 23B.06.200 entitled "Liability of Shareholders," referred to as piercing the corporate veil or the doctrine of corporate disregard. After the court makes its threshold decision to disregard the corporation entity, the court under the doctrine, then focuses on the individual liability of the shareholder(s) for the corporation's

liability. The court will then decide which of the shareholder(s) is individually responsible for corporation's liability. **See** "Washington's Doctrine of Corporate Disregard," 56 Wash. L. Rev 253 (1981).

New York Business Corporate Law § 1505 (a) is a model of clarity and provides as follows:

> §1505. Professional relationships and liabilities.
>
> (a) Each shareholder, employee or agent of a professional service corporation shall be personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by him or by any person under his direct supervisions and control while rendering professional services on behalf of such corporation.

The New York legislative history with regard to vicarious liability and the case decisions clearly exclude from vicarious liability innocent shareholders for third party claims. The negligent or wrongdoing shareholder(s) or employees as in Washington are subject to unlimited liability for third party claims.

The liability of the innocent shareholder(s) would be determined on which interpretation of RCW 18.100.070, the Washington Court would follow. There is no decided case in Washington, through the Washington Law Review article above notes some analogous cases that can be interpreted to absolve innocent shareholders of vicarious liability. Nationally, there have been a few judicial opinions on this subject.

The ***SECOND*** subsection of the statute restates the law in effect with respect to direct liability for third-party claims for negligence or wrong-doing of a shareholder(s). The ***SECOND*** subsection does not resolve this question regarding the imposition of vicarious liability on the innocent shareholder(s).

The ***THIRD*** subsection of the statute is clear. The Professional Corporation (and all of its assets) is liable for the professional negligence "committed by any of its directors, officers, shareholders, agents or employees…" and all of the corporation's assets are subject to such liability. Even if you were to successfully argue against vicarious liability of innocent shareholders, the assets of the corporation, representing the value of each respective shareholder's stock and all monies invested by the shareholder(s), still would be subject to judgment, levy and execution, *and loss*, to the extent of the uninsured liability.

**The Professional Limited Liability Company**

RCW 25.15.045 is the PLLC statute and provides certainty that the vicarious liability of innocent members as opposed to innocent shareholders that will be treated differently. Further, there are no current statutory interpretation issues swirling around RCW 25.15.045(2) as are in RCW 18.100.070.

Current Division I Court of Appeals Judge Marlin Appelwick was a State Representative ("Rep. Appelwick") and personally involved in the enactment of RCW 25.15.045. In 1994, Rep. Appelwick was a presenter at the WSBA seminar entitled "Limited Liability Companies in Washington #459" shortly after RCW 25.15 becoming law.

Subject to the limitation of ***LeBeuf v. Atkins***, 28 Wn App 50, 53 (1980) regarding legislative history[2], the seminar outline prepared by the Rep. Appelwick explains the history of RCW Chapter 25.15 and specifically RCW 25.15.045, as follows:

> Limited Liability: A Two-Edged Sword
>
> The LLC member enjoys exposure on the debts or torts of the LLC limited to the amount of the member's contribution. Derivative personal liability exposure of the general partner is absent. Personal liability is retained for the torts committed personally, however. The same is true for managers. (See RCW 25.15.125(2)) Liability within the company is limited to gross negligence, intentional misconduct, or knowing violation of law unless the company agreement provides otherwise. (See RCW 25.15.155(1))

For professionals, however, the mandatory insurance option was retained (RCW 25.15.045(2)). The insurance coverage was more common and more affordable. A one million dollar policy was believed sufficient to cover the vast majority of tort claims made against professionals. The statute is optional as a business form for professionals. The coverage was not seen as a deterrent to the use of LLCs by professionals.

> The insurance commissioner was given authority to establish higher mandatory limits for minimum liability coverage for professional LLCs. This was done in recognition that the amount of insurance needed to protect the public in an action for medical negligence against a surgeon may be greater than the amount needed for an action for negligent accounting by a solo accountant. It may be that a law firm doing securities work would require greater insurance than one doing primarily probate law. Initially, the legislature set one million dollars as the limit. The insurance commissioner has been encouraged not to adopt higher insurance

[2] "Any memos, reports, or statements not contained in a written committee report read into the journal, cannot be used to interpret legislative intent in passing the measure." *Id.* At 53, Footnote 1

> limits for a profession or specialty in the immediate future. To my knowledge, no such hearings are planned. Future action will likely depend upon the utilization of the LLC form by professionals upon the level of insurance coverage carried voluntarily.
>
> If a professional LLC does not carry the minimum insurance (or alternative) as required, the liability for the amount of the minimum required coverage becomes a joint and several liability of the members, if unsatisfied by the LLC. It, therefore, becomes important to have the insurance policy in place and the premium timely paid. Joint and several liability does not attach for amounts above the mandatory minimum of the required insurance coverage.

Rep. Appelwick's interpretation of RCW 25.15.045 (1) and (2) continues to be valid today. There are no contrary Washington court decisions.

The issue of the liability of innocent PLLC member(s) for professional negligence to third parties is clear in RCW 25.15.045(2). The innocent PLLC member's or employees' limit of liability is one million dollars. Vicarious liability does not attach to the innocent member(s) for amounts above one million dollars (or the future adjusted amount set by the Washington Insurance Commission). Pursuant to RCW 25.15.125(2) and RCW 25.15.045(2), the established law is continued for the application of unlimited liability for negligent members of the PLLC (as also in the case of negligent shareholders).

There would be little question that vicarious liability does not attach to innocent PLLC member(s). The PLLC entity assets for amounts above the mandatory one million dollar minimum may also be protected pursuant to the required minimum insurance of RCW 25.15.45(2). There is no decided case in Washington regarding the application of the RCW 25.15.0458(2) limitation to PLLC assets in the case of negligent member employee or agent. Of course, the negligent member(s) will continue to have unlimited liability for his/her negligence or wrongdoing to third parties.

### CONCLUSION

As a practical matter, in weighing the risks and certainty, multi-party organizations should be informed and counselled to avoid the uncertainties of incorporating a Professional Corporation versus forming a PLLC under RCW 25.15.045. The Washington Limited Liability Company Act provides greater certainty of protection to and limitations on the liability of innocent member(s) and the PLLC entity assets.

## SMLLC: *OLMSTEAD* AND *ALBRIGHT* CASES

### THE *OLMSTEAD* CASE

As of the date of this seminar, two cases have tested the protection of the single-member LLC (SMLLC) afforded to the single member (RCW 25.15.255; RCW 25.15.260).

**RCW 25.15.255**

**Rights of judgment creditor.**

> On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited liability company interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to the member's limited liability company interest.

**RCW 25.15.260**

**Right of assignee to become member.**

> (1) An assignee of a limited liability company interest may become a member upon:
>
> (a) The approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or
>
> (b) Compliance with any procedure provided for in the limited liability company agreement.
>
> (2) An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under a limited liability company agreement and this chapter. An assignee who becomes a member is liable for the obligations of his or her assignor to make contributions as

> provided in RCW 25.15.195, and for the obligations of his or her assignor under article VI of this chapter.
>
> (3) Whether or not an assignee of a limited liability company interest becomes a member, the assignor is not released from his or her liability to a limited liability company under articles V and VI of this chapter.

In ***Olmstead v. FTC***, 44 So. 3d 76 (Fla. 2010), 528 F.3d 1310 (11th Cir. 2008), the Eleventh Circuit Court of Appeals decision ignored the rights of the single member in an SMLLC. The decision was highly convoluted. The FTC obtained a $10,000,000 judgment against Shawn and Julie Olmstead and sought to collect the funds from the Olmsteads' Florida SMLLC. The Florida LLC Act (similar to Washington State's) allows an LLC member's creditors to reach only the member's interest in the LLC derived from partnership law called a "charging order." *See* RCW 25.15.255; RCW 25.15.260. The debtor, as the sole member, controls whether distributions of the LLC are made that would be subject to the charging order, but not the actual assets of the SMLLC or membership as a "member." The charging order was intended to protect the member's governance rights. The Florida court reviewed Florida's charging-order statute as an invitation to the Olmsteads to frustrate the debtor's creditors. Since the Florida legislature did not fix this perceived problem, the Florida Supreme Court chose to stay with its decision.

The court started out by rejecting the certified question! Finding itself unduly constrained by the charging-order provision, the court asked whether "Florida law" requires the surrender of all membership rights. The majority noted the policy issue that co-member consent to transfer of governance rights was not called for in single-member LLCs. But that still left the clear statutory language. The court dealt with this by reasoning that applying the charging-order provision would effectively abrogate the general execution statute, which makes various types of property, including corporate stock, subject to attachment and execution. The LLC, said the court without any basis or citation, is "a type of corporate entity." (Charging orders are not applicable in a corporate setting.) The LLC statute, while specifying the charging-order remedy, didn't say explicitly that was the "exclusive" remedy (as it had in other corporation statutes). This gave the court enough of a legal basis to apply the Florida general attachment statute and disregard the LLC charging order statute.

The dissenters also discussed, among other things, the obvious problem that the majority had usurped the legislature's role regarding the Florida LLC Act; that by relying on non-exclusivity it had unsettled creditor remedies for all LLCs and not just the single-member ones that they were worried about; that exclusivity is the only reasonable reading if the statute applies only one remedy; and that the court's remedy could support transferring management rights even if the judgment is for less than the value of the LLC interest.

**THE *ALBRIGHT* CASE**

The unpublished opinion in ***re Ashley Albright***, No. 01-11367 (Bankr. D. Colo. Apr. 4, 2003), illustrates the maxim "bad facts make bad law." The sole member of an SMLLC membership interest was transferred to the bankruptcy estate. Col. Rev. Stat. §§ 7-80-702 and 7-80-108(3)(a) are Colorado's "charging order" statutes similar to RCW 25.15.250, .255, and .260. The court disregarded the SMLLC entity on a technical reading of the charging order statute and held that the Trustee now controls the SMLLC and may cause the SMLLC to sell the assets of the SMLLC and distribute the net sale proceeds to the bankruptcy estate.

The court states in footnote 9 that this result would be different (i.e., the Trustee would not have the "right to govern the LLC") if the entity were an LLC of two or more members (the minimal membership interest); of course, if the debtor were a holder with another in a closely held corporation, the debtor's shares would be considered an asset of the debtor's estate which in this case would trigger the terms and conditions of a shareholder-type "buy-sell" agreement. In a sole-shareholder corporation, the shares would be transferred to the Trustee with full powers of corporate governance.

RCW 25.10.410 is the charging statute for limited partnerships and is identical to RCW 25.15.255.

I want to emphasize that the effect of the ***Albright*** and ***Olmstead*** cases is currently limited to single-member LLC/PLLCs allowed by RCW 25.15.005, though multimember LLCs could also be at risk under the ***Olmstead*** decision. A comparison of entity risk of personal liability as well as advising your client for full disclosure purposes is whether a single-member corporation electing Subchapter S or a single-member LLC/PLLC is more preferable for the client. Such factors would include but not be limited to whether your client is risk-adverse, its

business plan, financial strength and stability, experience and expertise in the business, debt-to-equity leverage, and tax consequences between entity choices.

Many planners contend that an SMLLC should provide no worse protection than that of a sole-shareholder corporation. Until the law is settled, I advise that your client be warned in writing that SMLLCs should be considered with caution until their effectiveness against inside liabilities is validated by case law, notwithstanding RCW 25.15.255.

## LLC MEMBER LIABILITY PROTECTION

Members of an LLC can participate in the management of the LLC and still gain personal liability protection under RCW 25.15.125, RCW 25.15.155, and RCW 25.15.160.

Members of an LLC are protected from "personal" liability for the debts of the LLC under RCW 25.15.125:

**RCW 25.15.125**

**Liability of members and managers to third parties.**

(1) Except as otherwise provided by this chapter, *the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort or otherwise, shall be solely the debts, obligations, and liabilities of the limited liability company*; and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation, or liability of the limited liability company solely by reason of being a member or acting as a manager of the limited liability company.

(2) A member or manager of a limited liability company is personally liable for his or her own torts.

An additional consideration for planning an entity choice is the potential of outside debts of a member. The LLC member's interest at the entity level is personal property under RCW 25.15.245, is subject to limited assignment under RCW 25.15.250, and is subject to a judgment creditor as a potential new member assignee and therefore subject to the potentially disruptive effect on the LLC and its other members under RCW 25.15.255 and RCW 25.15.260:

**RCW 25.15.245.**

**Nature of limited liability company interest – Certificate of interest.**

(1) A limited liability company interest is personal property. A member has no interest in specific limited liability company property.

(2) A limited liability company agreement may provide that a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.

**RCW 25.15.250.**

**Assignment of limited liability company interest.**

(1) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except:

(a) Upon the approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or

(b) As provided in a limited liability company agreement.

(2) Unless otherwise provided in a limited liability company agreement:

(a) An assignment entitles the assignee to share in such profits and losses, to receive such distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and

(b) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his or her limited liability company interest.

## SPECIAL TAX ALLOCATION

A tax advantage shared by partnerships and LLCs taxed as partnerships is the ability to make special allocations of income, loss, and credits to their partners or members under RCW 25.15.200 and 25.15.205. By making special allocations, an LLC can pass along tax benefits (e.g., depreciation deductions) to the members best able to take advantage of them and

also gain considerable other tax-planning flexibility. Special allocations are allowed as long as they have "substantial economic effect" and meet all other tax law requirements.

## ENTITY INTEREST

Similar to a corporation, a member's interest is a percentage ownership of the entity – not the assets of the entity. *See* RCW 25.15.200; RCW 25.14.205. This distinguishes the LLC interest from a partnership interest (i.e., aggregate vs. entity theory).

## WILL AN LLC ALWAYS BE TAXED AS A PARTNERSHIP?

Classification of an LLC as a partnership for federal income tax purposes is not automatic. The specific characteristics of the LLC determine its classification as a partnership or as an association taxable as a corporation and avoid being subject to corporate income taxes.

These are **four of the key features** that distinguish a corporation for federal tax purposes:

1. Continuity of life.
2. Centralized management.
3. Free transferability of interests.
4. Liability for corporate debts limited to corporate property.

To qualify for partnership tax status, an LLC can generally have no more than two of these four corporate characteristics.

When an LLC is taxed as a partnership, each member's share of income from the LLC generally is taxable as earnings from self-employment. Some LLC members, however, may be able to limit their self-employment income to guaranteed payments received for services to the LLC. The point is that LLC members, as partners in a partnership, will report their respective share of income, loss, deductions, and credits at graduated individual tax rates on their 1040 tax returns, which is also equivalent to a partnership and a limited liability partnership.

## SECTION 5: IRS FORM 8832 ELECTIONS

In 1997, the IRS issued new regulations that generally allowed any LLC to choose whether it was to be taxed as a partnership or a corporation (association) by "checking the box" as to what type of taxable entity it wanted to be and allowing single-member LLCs to be ignored as entities for tax purposes (a "disregarded entity") equivalent to a sole proprietorship for tax-reporting treatment. If no election is made, the single-member LLC/PLLC will be characterized as a disregarded entity for federal tax purposes. The effect is that no additional return (i.e., Form 1065, "Partnership Income Tax Return") will need to be prepared. All the LLC/PLLC income and expenses are reported in the member's Form 1040 individual income tax return, Schedule C.

Unless an election is made on IRS Form 8832, a domestic eligible entity is:

1. Classified for tax purposes as a partnership if it has two or more members (and is not a corporation);
2. A single member LLC (SMLLC) is classified for tax purposes as a disregarded entity and not treated as separate from its single owner for tax purposes.

A change in the number of members of an eligible entity classified as a corporation does not affect the entity's classification election. But an eligible entity classified as a multi-member partnership (MMLLC) can become an SMLLC if it is reduced to one member or if a SMLLC becomes a MMLLC (addition of one or more members) it will be classified as a partnership and not a disregarded entity.

The classification significance arises because the IRS charges a penalty if you file the Form 1065 past its due date (usually April 15$^{th}$) without an extension to file. The penalty is $195.00 per month multiplied by the total number of partners in the partnership. The penalty can become significant!

Following, Form 8832 instructions provide:

> A disregarded entity is an eligible entity that is treated as an entity that is not separate from its single owner. Its separate existence will be ignored for federal tax purposes unless it elects corporate tax treatment.

The federal tax treatment of elective changes in classification as described in Treas. Reg. § 301.7701-3(g)(1) is summarized in the instructions to Form 8832 as follows:

- If an eligible entity classified as a partnership elects to be classified as an association, it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.
- If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.
- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

IRS Form 8832, "Entity Classification Election," is included as an attachment. Please review the "Form of Entity" checklist carefully.

**EXAMPLE 1:** An SMLLC can elect on Form 8832 under 2(a) to be treated for tax purposes as a corporation and further elect on Form 2553, "Election by a Small Business Corporation," to be classified as a Subchapter S corporation. Why?

Two or more owner LLCs are treated by default as a partnership – a "pass through entity" – unless the members elect corporate tax treatment by filing and checking the box on IRS Form 8832 to avail themselves of the income and employment tax benefits of a Sub-chapter S election.

The partnership to be classified as a corporation will be deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.

**EXAMPLE 2:** If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

**EXAMPLE 3:** If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.

**EXAMPLE 4:** If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

## SECTION 6: DISREGARDED-ENTITY ISSUE IN WASHINGTON STATE

Washington state community-property law can interject a tax-planning issue into the LLC/PLLC selection. For example, if a wife is the only member in an LLC/PLLC and her husband has a Washington state community-property interest in her LLC/PLLC member interest, can the LLC/PLLC ever be a single-member limited liability company for tax purposes?

- The LLC, the husband and the wife, can treat the LLC as a partnership or as a single-member limited liability company (Rev. Proc. 2002-69, I.R.B. 1, released October 9, 2002).

If the husband and wife are both members, there are no other members, and the husband and wife own their interests entirely as community property, can the LLC ever be a single-member limited liability company for tax purposes?

- The LLC, the husband and the wife, can treat the LLC as a partnership or as a single-member limited liability company.

If the husband or wife or both hold the interest in a grantor trust of which he, she, or both are grantors, there are no other members, and the husband and wife own their interests entirely as community property, can the LLC ever be a single-member limited liability company for tax purposes?

- The LLC, the husband and the wife, can treat the LLC as a partnership or as a single-member limited liability company, because the grantor trust is disregarded for income tax purposes.

The LLC can flip back and forth from single-member limited liability company status to partnership classification, but the change is a conversion for check-the-box purposes.

These rules do not apply if the husband or wife holds any interest in the LLC in any form other than community property.

Assume that a husband and wife are both members, but only the wife is active in the business. How much of the LLC's income is subject to self-employment tax?

- If the LLC is disregarded, all the income is probably subject to self-employment tax.

- If the LLC is treated as a partnership, probably only the wife's share is subject to self-employment tax. The husband's share would be subject only to income tax. The husband will be generally recognized as a de facto limited partner (similar to a limited partnership) in "safe harbor" IRS proposed regulations.

If a husband and wife are both named as members in the operating agreement, I count two members and would treat the LLC/PLLC as a partnership. If only the husband or wife is named as single member in the operating agreement, the LLC/PLLC would qualify as a disregarded LLC/PLLC. To comply with Rev. Proc. 2002-69, I would state whether the husband, wife, or both are the members and memorialize the election in the operating agreement to disregard the LLC/PLLC or treat it as a partnership.

## SECTION 7: CHOICE-OF-ENTITY REVIEW

A one-person LLC will be treated as a disregarded entity – unless the owner elects corporate tax treatment by filing Form 8832, "Election." Thus, a sole proprietorship that becomes an LLC/PLLC will continue to be treated as a sole proprietorship by the IRS, and an LLC/PLLC with a sole corporate member will be treated as just another division of the corporation, and not treated as a separate legal entity.

RCW 25.15.005(4) allows single-member LLCs, subject to the caveats regarding outside and inside liability. Almost any sole proprietor can choose to become an LLC/PLLC. You will gain the benefits of limited liability for the sole proprietorship without any increase in the federal tax compliance or tax liability. By contrast, if you incorporate your business to gain limited liability, you become subject to federal corporate tax issues plus a much more complicated tax compliance requirements. (Of course, there are still situations in which certain corporate tax advantages may outweigh such disadvantages. For example, S corporation status is often preferable to a PLLC for professional firms, since profits not paid out by an S corporation as salary will not be subject to self-employment tax as Subchapter S dividends – *see Chart A* to compute tax dollar effect.)

In a nutshell, if you select an LLC/PLLC entity, your earnings will be taxed as self-employment income to its member(s) and be fully subject to employment taxes set forth in Chart A as well as ordinary income taxes.

Alternatively, if you choose a corporate entity and elect Subchapter S status, the S corporation earnings will be taxed differently from an LLC/PLLC entity's.

For tax-reporting purposes, Subchapter S earnings are characterized as a reasonable salary to its owner-employee(s), with the balance of the earnings treated as a Subchapter S dividend. Only the salary will be subject to employment taxes as well as ordinary income tax.

The Subchapter S dividend will be subject only to ordinary income tax. The Subchapter S dividend is not employment income subject to employment taxes. Characterization of percentage of corporate income as a reasonable salary and Subchapter S dividend is a tax-wise

strategy to minimize the payment of employment taxes. This strategy is a sound reason to choose a corporate entity rather than an LLC/PLLC entity.

In a partnership, an individual general partner's distributive share of ordinary income from a trade or business will constitute net earnings from self-employment (NESE). A limited partner's distributive share of such income will not constitute NESE except to the extent of amounts of guaranteed payments for services.

## SECTION 8: TAXATION OF SUBCHAPTER S CORPORATIONS

The S corporation flow-through income has long enjoyed an employment tax advantage over that of sole proprietorships, partnerships, and LLCs. The advantage finds its genesis in Rev. Rul 59-221, which held that a shareholder's undistributed share of S corporation income is not treated as self-employment income. In contrast, earnings attributed to a sole proprietor, a general partner, or many LLC members are subject to self-employment taxes.

In late 2010, an Iowa district court decided ***David E. Watson, P.C. v. United States,*** 714 F. Supp 2d 954 (S.D. Iowa 2010); 757 F. Supp 2d 877 (S.D. Iowa 2010), a reasonable-compensation case that, together with the North Dakota District Court's 2006 decision in ***JD & Associates, Ltd. v. United States***, No. 3:04-CV-59 (D.N.D. May 19, 2006), provides the direction that tax advisers have been seeking. ***Watson*** and ***JD & Associates*** shed much-needed light on the methodology that the IRS and the courts use to determine reasonable compensation in the S corporation arena, providing an analytical approach that tax advisers can follow when guiding their clients.

In ***JD & Associates***, Jeffrey Dahl was the sole shareholder of JD & Associates, an accounting firm taxed as an S corporation. Dahl was a CPA with over 20 years of experience, and he ran a very successful firm. He was responsible for making all of the firm's hiring decisions, paying its bills, maintaining its books and records, preparing its tax returns, and preparing and reviewing tax returns for the firm's clients.

Despite this laundry list of responsibilities, Dahl drew a salary of only $19,000 in 1997, $30,000 in 1998, and $30,000 in 1999, opting instead to take distributions from the S corporation totaling $47,000 in 1997, and $50,000 in both 1998 and 1999.

The IRS asserted that Dahl's compensation was unreasonably low, citing his responsibilities as managing partner of the firm. Engaging the services of a certified valuation engineer (the IRS expert), the IRS made its own determination of reasonable compensation for Dahl's services.

The IRS expert, using a national survey of financial ratios conducted by Risk Management Association (RMA), compared the following financial ratios of JD & Associates and Dahl to those of accounting firms with comparable asset levels:

- JD & Associates' after-tax profit as a percentage of net sales. The resulting ratio confirmed that JD & Associates was 200% to 300% more profitable than its peers.

- Dahl's salary as a percentage of net sales. The resulting ratio confirmed that Dahl's compensation was 166% to 266% less than that of his peers.

The IRS expert then normalized Dahl's compensation by the average officers' compensation percentages found in the RMA survey and determined his reasonable compensation to be $69,584 in 1997, $79,823 in 1998, and $79,711 in 1999.

In reaching its decision in favor of the IRS, the North Dakota District Court condensed nine factors previously used by the Eighth Circuit to determine reasonable compensation in the C corporation arena into the following three groupings:

- Employee performance;

- Salary comparisons; and

- Company conditions.

In examining the first factor, the court cited JD & Associates' after-tax profit as a percentage of sale and concluded that Dahl's performance as head of JD & Associates was exemplary. Thus, the court stated that Dahl's compensation was "not congruent to his performance."

The comparison of salaries also evidenced that Dahl's salary was unreasonable. The court noted that Dahl had taken a salary barely in excess of that of his subordinate employees and failed to receive a raise in 1998 and 1999 despite JD & Associates' increase in gross receipts during those years.

Finally, the conditions of the company dictated higher pay for Dahl. Because it was a small enterprise with few requirements in terms of reinvestment, the court believed there was excess capital for employee compensation, which would allow for a higher salary than Dahl had received.

Having found that all three factors of its test weighed against Dahl, the court concluded that Dahl's compensation was unreasonably low and upheld the IRS's re-characterization of distributions to wages of $42,817 in 1997, $33,072 in 1998, and $35,582 in 1999.

Compensation:

| | | |
|---|---|---|
| Salary: | 1997 | $19,000 + $42,817 = $61,817-new salary |
| | 1998 | $30,000 + $33,072 = $63,072-new salary |
| | 1999 | $30,000 + $35,582 = $65,582-new salary |

Subchapter S Dividend:

| | |
|---|---|
| 1997 | $47,000 - $42,817 = $4,183-new distribution |
| 1998 | $50,000 - $33,072 = $16,928-new distribution |
| 1999 | $50,000 - $35,582 = $14,418-new distribution |

At the end of 2010, an Iowa district court decided ***Watson***, offering another detailed look at the methodology employed by the IRS and the courts in determining reasonable compensation.

David Watson, like Jeffrey Dahl, was a CPA. He was also the sole shareholder and employee of DEWPC, an S corporation, which in turn was a 25% shareholder in LWBJ, a successful accounting firm. During 2002 and 2003, LWBJ exceeded $2 million in gross revenues. Watson typically worked 35 to 40 hours a week providing tax services to the firm's clients.

As the sole shareholder of DEWPC, Watson set his annual compensation at $24,000 for both 2002 and 2003. Watson received distributions from DEWPC of $203,651 and $175,407, respectively, in those years.

The IRS maintained that Watson's compensation was unreasonably low based on the services he provided to DEWPC. The IRS engaged the services of the same general engineer used in ***JD & Associates*** to determine an amount of reasonable compensation.

In doing so, the IRS again sought to determine Watson's compensation relative to that of his peers and subordinates. The IRS expert used the RMA annual statement studies to determine that DEWPC was at least three times more profitable than comparably sized firms in the accounting field. Using the data from Robert Half, a large international specialized staffing-services firm, and a University of Iowa survey, the IRS expert found that individuals in positions subordinate to Watson were paid significantly more in compensation.

To quantify the amount of reasonable compensation, the IRS expert turned to the Management of an Accounting Practice (MAP) survey conducted by the American Institute of Certified Public Accountants (AICPA) specific to the Iowa Society of CPAs. The MAP indicated that an average director (defined as solely an employee with no shareholder interest) in a firm the size of DEWPC would realize approximately $70,000 in compensation annually. The IRS expert then determined that, on average, an owner (defined as both a shareholder and an employee in a firm) such as Watson billed at a rate approximately 33% higher than did a director. The IRS expert grossed up the $70,000 in director compensation by 33% to reflect Watson's ownership interest, resulting in reasonable annual compensation of $93,000.

The district court held in favor of the IRS. The court, citing Watson's 20 years of experience, advanced degree, and hours per week he spent as one of the primary earners at the well-established firm, concluded that any reasonable person in Watson's position at such a profitable firm would be expected to earn far more than a $24,000 salary. The court agreed with the IRS that a reasonable salary in both 2002 and 2003 would be $91,044; correspondingly, it reclassified $67,044 of Watson's distributions in each of those years as compensation, holding DEWPC liable for payroll taxes on the reclassified amounts.

Compensation:

| | | |
|---|---|---|
| Salary: | 2002 | $24,000 + $67,044 = $91,044-new salary |
| | 2003 | $24,000 + $67,044 = $91,044-new salary |

Subchapter S Dividend:

| | |
|---|---|
| 2002 | $203,651 - $67,044 = $136,607-new distribution |
| 2003 | $175,470 - $67,044 = $108,426-new distribution |

In computing a reasonable salary, tax advisers should take a lesson from ***JD & Associates*** and ***Watson*** and perform an analysis using the factors in these two cases. In particular, advisers should give several of the factors careful consideration. Contrary to what most commentators say, JD & Associates and Watson were in actuality winners. Both minimized their respective employment taxes (FICA and Medicare) and validated the benefit of a closely held Subchapter entity choice over an LLC, LLP, or sole proprietorship.

It is likely that the limitation on the amount of Social Security wages subject to payroll tax will continue to increase, with some suggesting that Congress might remove it entirely. If this were to occur, the likelihood of abuse would only increase. Suffice it to say that ***Watson*** will not be the last we hear regarding S corporation reasonable compensation.

## SECTION 9: PROFESSIONAL LIMITED LIABILITY COMPANIES (PLLCs)

Limited liability companies are rapidly growing in popularity. Chapter 25.15 RCW *et seq.* is the limited liability company statute in the state of Washington.

RCW 25.15.045 authorizes professional limited liability companies. Chapter 18.100 RCW refers to professional service corporations.

**RCW 25.15.045**

**Professional limited liability companies.**

(1) A *person or group of persons* licensed or otherwise legally authorized to render professional services within this or any other state may organize and become a member or members of a professional limited liability company under the provisions of this chapter for the purposes of rendering professional service. A "professional limited liability company" is subject to all the provisions of chapter

18.100 RCW that apply to a professional corporation, and its managers, members, agents, and employees shall be subject to all the provisions of chapter 18.100 RCW that apply to the directors, officers, shareholders, agents, or employees of a professional corporation, except as provided otherwise in this section. …

(a) At least one manager of the company is duly licensed or otherwise legally authorized to practice the profession in this state; or

(b) Each member in charge of an office of the company in this state is duly licensed or otherwise legally authorized to practice the profession in this state.

(2) If the company's members are required to be licensed to practice such profession, and the company *fails to maintain* for itself and for its members practicing in this state *a policy of professional liability insurance, bond, or other evidence of financial responsibility* of a kind designated by rule by the state insurance commissioner and *in the amount of at least one million dollars or a greater* amount as the state insurance commissioner may establish by rule for a licensed profession or for any specialty within a profession, taking into account the nature and size of the business, then the company's members are personally liable to the extent that, had the insurance, bond, or other evidence of responsibility been maintained, it would have covered the liability in question.

(3) For purposes of applying the provisions of chapter 18.100 RCW to a professional limited liability company, the terms "director" or "officer" means manager, "shareholder" means member, "corporation" means professional limited liability company, "articles of incorporation" means certificate of formation, "shares" or "capital stock" means a limited liability company interest, "incorporator" means the person who executes the certificate of formation, and "bylaws" means the limited liability company agreement.

(4) The name of a professional limited liability company must contain either the words "Professional Limited Liability Company," or the words "Professional Limited Liability" and the abbreviation "Co.," or the abbreviation "P.L.L.C." or "PLLC" provided that the name of a professional limited liability company organized to render dental services shall contain the full names or surnames of all members and no other word than "chartered" or the words "professional services" or the abbreviation "P.L.L.C." or "PLLC."

RCW 25.15.045(2), written in the negative, is extremely important to licensed professionals. The LLC and its members must purchase and maintain $1 million of professional liability insurance to provide $1 million of limited liability between its individual members for liability for professional negligence of innocent members and the LLC entity assets. This is a potential advantage for professionals organizing as a PLLC in the state of Washington rather than as a RCW Chapter 18.100 professional service corporation.

## SECTION 10: ENTITY-SPECIFIC RULES FOR CHOICE OF PROFESSIONAL SERVICES

It is important for any person providing licensed services in the state of Washington (lawyer or doctor) to select the correct professional services entity. Otherwise, a licensed professional may be in violation of the following statutes (for example, Chapter 18.100 RCW, RCW 25.15.045, and RCW 25.05.510). The selection of the wrong entity by a lawyer could also violate the Washington Rules of Professional Conduct (RPC) (for example, RPC 8.4 for misrepresentation and fitness to practice law and RPC 1.1 for competency to practice law).

In Washington state, a licensed professional has the choice to form and/or incorporate only certain types of entities, namely, a sole proprietorship, general partnership (Chapter 25.05 RCW), professional service corporation (Chapter 18.100 RCW), professional limited liability company (RCW 25.15.045), or (professional) limited liability partnership (Chapter 25.05.510). A licensed professional cannot incorporate as a business corporation (Chapter 23.13 RCW) or form a limited liability company (Chapter 25.15 RCW) to render licensed professional services in Washington. Frequently, the confusion arises out of the second sentence in RCW 25.15.045 that provides, in part, "render professional services… may organize and become a member." The "may" is confusing because it implies that a PLLC is not mandatory, which it is, of course, if you intend to form a limited liability company to perform professional services.

Chapter 18.100 RCW and RCW 25.15.045 impose specific requirements and limitations that need to be included in the entity's formation and/or incorporation documents, including the bylaws or operating agreement. The Secretary of State's professional entity forms on its website do not include any mandatory provisions required by the professional services statutes. It is up to the drafter to add these provisions (of Chapter 18.100 RCW and RCW 25.15.045) to the website formation and/or incorporation forms. If this is not accomplished, the entity is technically not in compliance with the professional services statutes.

The RPCs affect those who form the wrong entity in Washington. The selection of the wrong type of entity could violate the RPCs. RPC violations to be aware of include RPC 8.4(c) (to engage in conduct involving dishonesty, fraud, deceit, or misrepresentation) and RPC 8.4(n) (to engage in conduct demonstrating unfitness to practice law). Also, RPC 5.5 pertains to not

practicing in violation of a regulation and states, in part, "A lawyer may practice law only in a jurisdiction in which the lawyer is authorized to practice." RPC 7.1 pertains to false and misleading advertising and communication and states, in part, "A lawyer shall not make false or misleading communication about the lawyer or the lawyer's services." RPC 1.1, pertaining to competency, states, in part, "Competent representation requires the legal knowledge, and skill . . . necessary for the representation." A lawyer may not employ the requisite knowledge and skill if the lawyer's services are provided through the wrong entity thereby violating this RPC.

If you have selected the wrong entity type or have not completed your incorporation and/or formation documents correctly, you will need to take corrective action immediately to comply with the respective professional services statutes. The solution usually requires filing amended articles or certificate of formation and amending and restating the bylaws or operating agreement, and holding a special meeting of shareholders and/or members to approve and authorize the filing of the amendments and governance documents. Then, correct the entity's name on your business cards, letterhead, checking accounts, and website.

## SECTION 11: SOLE PROPRIETORSHIPS

A proprietorship is the most basic business entity. There is no limited liability for any debts or obligations incurred. The individual is personally liable. For a professional, liability insurance can provide protection for professional negligence, subject to a deductible set forth in the policy, and public liability insurance can provide protection against public claims; the individual, however, is still personally liable for operating liabilities (e.g., office rent, office equipment rentals, and payroll).

As an overview, the as defined Code provides that gross income consists of all income from all sources, such as compensation for services, earned between January 1 and December 31. Individuals and corporations can deduct ordinary and necessary expenses paid or incurred in conducting a business, net capital expenditures, and applicable depreciation deductions and credits. The difference between gross income and deductions is generally referred to as "taxable income."

Proprietorship business gross income, expenses, and taxable income are reported on Schedule C of Form 1040 individual tax return.

## SECTION 12: PROFESSIONAL SERVICE CORPORATIONS (PSs) SPECIFICS

Chapter 18.100 RCW is the Washington State Professional Service Corporation Act.

RCW 18.100.030 defines the following terms applicable to this outline:

> (1) The term "professional service" means any type of personal service to the public which requires as a condition precedent to the rendering of such service the obtaining of a license or other legal authorization and which prior to the passage of this chapter and by reason of law could not be performed by a corporation, including, but not by way of limitation, certified public accountants, chiropractors, dentists, osteopaths, physicians, podiatric physicians and surgeons, chiropodists, architects, veterinarians and attorneys at law.

RCW 18.100.050 authorizes a broad range of licensed professionals to render services in one professional service entity.

RCW 18.100.070 restates the existing professional liability policy of the state of Washington between the professional services provider (PS shareholder-employee) and his or her respective patient or client:

**RCW 18.100.070**

**Professional relationships and liabilities preserved.**

> Nothing contained in this chapter shall be interpreted to abolish, repeal, modify, restrict or limit the law now in effect in this state applicable to the professional relationship and liabilities between the person furnishing the professional services and the person receiving such professional service and the standards for professional conduct. *Any director, officer, shareholder, agent or employee of a corporation organized under this chapter shall remain personally and fully liable* and accountable for any negligent or wrongful acts or misconduct committed by him or by any person under his direct supervision and control, *while rendering professional services* on behalf of the corporation to the person for whom such professional services were being rendered. *The corporation shall be liable for any negligent or wrongful acts of misconduct committed* by any of its directors, officers, shareholders, agents or employees while they are engaged on behalf of the corporation, in the rendering of professional services.

RCW 18.100.110 generally provides that nonlicensed professionals may not own or receive an ownership interest through the transfer of shares in a PS. The one exception is the licensed certified public accounting professional corporation or professional limited liability company:

**RCW 18.100.110**

**Sale or transfer of shares.**

> No shareholder of a corporation organized as a professional corporation may sell or transfer his or her shares in such corporation except to the trustee of a qualified trust or another individual who is eligible to be a shareholder of such corporation. Any transfer of shares in violation of this section shall be void. However, nothing in this section prohibits the transfer of shares of a professional corporation by operation of law or court decree.

For ease of conversion to a PS from an existing RCW 23B corporation, the corporation's articles of incorporation can be easily amended to comply with RCW 18.100 to form a PS after the Washington Secretary of State's loss of appeal in the ***Knight*** case.[3]

## SECTION 13: THE "C" STATUS CORPORATIONS

A C corporation pays income tax on profits at the corporate level, rather than its individual shareholders, *until* the profits are distributed to the shareholders as a dividend and thereafter taxed at a maximum income tax rate of 20% in 2014 to the shareholder for qualified dividends.

[3] Knight was represented by the author.

| 2014 Corporate Income Tax Rates (for C Corporation) | | | |
|---|---|---|---|
| **Over** | **But not over** | **The tax is** | **Of excess over** |
| $0 | $50,000 | 15% | $0 |
| 50,000 | 75,000 | $7,500 + 25% | 75,000 |
| 75,000 | 100,000 | 13,750 + 34% | 100,000 |
| 100,000 | 335,000 | 22,250 + 39% | 100,000 |
| 335,000 | 10,000,000 | 113,900 + 34% | 335,000 |
| 10,000,000 | 15,000,000 | 3,400,000 + 35% | 10,000,000 |
| 15,000,000 | 18,333,333 | 5,150,000 + 38% | 15,000,000 |
| 18,333,333 | | 35% | 0 |

Corporations that have made an S election generally are not taxed at the corporate level. Instead, their net income passes through and is taxed directly to the shareholders on their personal income tax returns. Profits for a partnership, LLP, LLC, and Subchapter S corporation are not taxed at the entity level, but the partners of a partnership or an LLP, the members of an LLC, and the shareholders of a Subchapter S corporation must recognize profits for the tax year and automatically include them in a partner's, member's, or shareholder's income through a partnership, LLP, LLC, or Subchapter S corporation - thus not being subject to double taxation, as are C corporation profits.

C corporations cannot deduct a dividend and the shareholders must include the dividend as taxable ordinary income on their personal returns, hence double taxation (for example, a 35% corporate tax rate *plus* a 20% 2014 maximum tax rate on qualified dividend income (2004 Act) = a 55% *maximum combined tax rate*).

Corporate investment and operating losses in a C corporation do not pass through to the shareholders, but are carried over at the entity level.

Compensation in the form of salary or bonus is taxable income to the employee and a deduction to the gross income of the corporation. The compensation is subject to employment taxes.

The balance of any corporate net income is either accumulated at regular corporate tax rates or effectively taxed and distributed as a dividend to the shareholders.

Federal corporate taxation is a vast and complex subject - with "thousand page" treatises not being uncommon and its complexities are beyond the scope of this survey outline.

## SECTION 14: PERSONAL SERVICE CORPORATIONS (PSCs)

If the C corporation predominantly provides personal services (professional included), there is a flat federal tax rate of 35% (which for a C corporation is the rate for taxable income exceeding $75,000 in 2014) on personal service corporation income (IRC § 269A, § 448(d)(2), and § 11(b)(2)).

IRC § 448(d)(2) defines a qualified personal service corporation as follows:

> (2) QUALIFIED PERSONAL SERVICE CORPORATION - The term "qualified personal service corporation" means any corporation -
>
> (A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and
>
> (B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by –
>
> (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),
>
> (ii) retired employees who had performed such services for such corporation,
>
> (iii) the estate of any individual described in clause (i) or (ii), or

(iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

Of note is IRC § 448(d)(2)(B)(i)-(iv) - piercing a multiple-entity strategy originally designed to isolate employees from shareholders for tax purposes. This is not a multiple-entity strategy that is now effective.

## SECTION 15: SPECIAL ALLOCATIONS

A tax advantage shared by partnerships and LLCs taxed as partnerships is the ability to make special allocations of income, loss, and credits to their partners or members under RCW 25.15.200 and 25.15.205 and the Partnership Chapter of the Code. By making special allocations, an LLC can pass along tax benefits (e.g., depreciation deductions) to the members best able to take advantage of them and also gain considerable other tax-planning flexibility. Special allocations are allowed as long as they have "substantial economic effect" and meet all other tax-law requirements.

## SECTION 16: C AND S CORPORATION TAX DIFFERENCES

The tax differences between a C corporation and an S corporation are significant.

(1) S corporation advantages:

(a) No tax at corporate level/lower tax rates on earnings at individual level.

(b) Avoids a second tax on dividend distributions.

(c) Eliminates accumulated earnings tax problems.

(d) Avoids qualified personal services corporate flat rate.

(e) Stockholder receives basis for undistributed earnings.

(f) Can utilize cash method even if gross receipts exceed $5 million.

(g) Passes through losses to shareholders.

(h) Saves on self-employment taxes.

(2) S corporation disadvantages:

(a) Limits selection of fiscal year-ends - requires December 31 year-end.

(b) Certain fringe benefits are not deductible for stockholders holding 2% or more of the stock that would be deductible to a C corporation.

(c) Cannot be a member of an affiliated group.

(d) Limits number and type of shareholders to 75.

(3) C corporation advantages:

(a) Can accumulate income at lower corporate rates if individual shareholder's tax rate exceeds 35%.

(b) Flexibility to choose any fiscal year-end subject to limit.

(c) Certain fringe benefits are deductible for stockholders holding 2% or more of stock that would not be deductible as an S corporation.

(d) No built-in gains problem.

(e) Can be part of an affiliated group.

(f) No limit on number or type of shareholders.

(4) C corporation disadvantages:

(a) Incurs a second tax on dividend distributions.

(b) Potential for tax on accumulated earnings.

(c) Stockholder does not receive basis for undistributed earnings.

(d) Cannot utilize cash method if gross receipts exceed $5 million.

(e) Losses may not be used by shareholders.

## SECTION 17: ELECTING SUBCHAPTER S CORPORATE STATUS

For tax purposes in this outline, there are two distinct corporate organizations: (i) a Subchapter C corporation if no Subchapter S election is made; and (ii) a Subchapter S

corporation if the Subchapter S election is made on Form 2553 under IRC § 1361(a) and § 1362(a). IRC § 1362(b) details when the election must be made:

**TITLE 26, Subtitle A**

**CHAPTER 1, Subchapter S**

**PART I**

**SEC. 1361. S CORPORATION DEFINED.**

**(a) S CORPORATION DEFINED –**

(1) IN GENERAL - For purposes of this title, the term ‘‘S corporation’’ means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

(2) C CORPORATION - For purposes of this title, the term ‘‘C corporation’’ means, with respect to any taxable year, a corporation which is not an S corporation for such year.

**(b) SMALL BUSINESS CORPORATION –**

(1) IN GENERAL - For purposes of this subchapter, the term ‘‘small business corporation’’ means a domestic corporation which is not an ineligible corporation and which does not -

(A) have more than 100 shareholders,

(B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

**SEC. 1362. ELECTION; REVOCATION; TERMINATION**

(a) **ELECTION –**

(1) IN GENERAL - Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

(2) ALL SHAREHOLDERS MUST CONSENT TO ELECTION - An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(b) **WHEN MADE –**

(1) IN GENERAL - An election under subsection (a) may be made by a small business corporation for any taxable year -

(A) at any time during the preceding taxable year, or

(B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.

(2) CERTAIN ELECTIONS MADE DURING 1ST 2½ MONTHS TREATED AS MADE FOR NEXT TAXABLE YEAR

(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3rd month of such year, but

(B) either -

(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or

(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election, then such election shall be treated as made for the following taxable year.

(3) ELECTION MADE AFTER 1ST 2½ MONTHS TREATED AS MADE FOR FOLLOWING TAXABLE YEAR - If -

(A) a small business corporation makes an election under subsection (a) for any taxable year, and

(B) such election is made after the 15th day of the 3rd month of the taxable year and on or before the 15th day of the 3rd month of the following taxable year, then such election shall be treated as made for the following taxable year.

(4) TAXABLE YEARS OF 2½ MONTHS OR LESS - For purposes of this subsection, an election for a taxable year made not later than 2 months and 15 days after the first day of the taxable year shall be treated as timely made during such year.

(5) AUTHORITY TO TREAT LATE ELECTIONS, ETC., AS TIMELY – If -

(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year or no such election is made for any taxable year, and

(B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year (and paragraph (3) shall not apply).

A practice tip: Rev. Rul 86-110, 1986-2 CB 150 provides that IRC § 1362(f) can save a Subchapter S election from the inadvertent inclusion of a non-qualified shareholder. Numerous revenue rulings with several principal rulings can be followed to save a Subchapter S election under a number of circumstances leading to the loss of the election. I have used several specialized texts to research and prepare such a request to the IRS. If this situation arises in your practice, be aware that there may be a solution and that you need to consult specialized tax services to prepare your request.