

Setting Up, Managing, and Marketing Your Practice

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Differences in Business Structures and Protections in Human Service Private Practice: Which Suits Your Practice Best?

Jonathan D. Nye

Whether you have already established your own practice, are starting a practice of your own, are joining a practice, or are working for a practice that is already established, the “business” of practice as a mental health or human services professional is the framework within which professional care is delivered. A successful practice requires the knowledge and implementation of basic legal, financial, and business management skills. We present here an overview of some legal aspects of practice structure to assist the practitioner in establishing, evaluating and improving the business of the practice.

The business of being a service provider includes such mundane activities as:

- Securing, contracting for, and equipping adequate office space, telephone, Internet, and fax service; design and furnishings; and a secure filing system.
- Development and implementation of legal and ethically based practice forms and policies.
- Compliance with state and federal tax, licensing, and confidentiality law and practice.
- Business accounting.
- Marketing/practice development.
- Staff acquisition, training, and supervision.
- Policies, procedures, and implementation of day-to-day business activities such as calendaring, billing, and collections for services provided.

All of these “business” matters are affected in one way or another by the form of practice entity chosen for the firm. There are benefits, concerns, and obligations

associated with each. Keep in mind that the laws of each state and its licensing bodies (departments of professional regulation) will differ in requirements, restrictions, and protections. These are highly complex matters and require professional consultation and assistance.

CHOICE OF BUSINESS ENTITY: PROTECTION AGAINST PROFESSIONAL LIABILITY CLAIMS

One of the primary purposes of establishing a practice entity is to limit liability, or one's financial exposure, for *damages* arising out of a wrongful act or omission by a professional or a dangerous condition on the premises.

Professional liability describes legal obligation arising out of a professional's errors, acts, or omissions during the course of practicing his or her profession. Generally, if someone claims injury as a result of either intentional malfeasance or negligent deviation by a professional from the standard of care recognized by the profession ("malpractice"), the professional will be liable for such injury which, in the law, is characterized as *damages*.

Professional liability usually takes the form of a legal action alleging professional negligence or malpractice. Professional liability and discipline by licensing authorities and professional associations can occur when a professional negligently or deliberately deviates from the standard of care of a reasonable professional under the circumstances of the case. An example of a deliberate wrongful act might be a mental health provider engaging in a dual relationship with a patient or client, acting or failing to act in a professional manner, mismanages a transference or countertransference, or engages in undue familiarity with a client. This could range from engaging in a social relationship with a client to engaging in a sexual or business relationship with a client. In either case, the professional and, potentially, his or her partners, supervisors, employers, or others in the practice may be held liable, depending on the act or omission complained of as well as the business structure of the practice.

Premises liability can attach if someone is injured on the business premises property as a result of a hazardous condition, such as ice, snow, standing water, holes in the floor or pavement, insufficient lighting, or defects in furniture. Premises liability may be avoided or minimized by reasonable efforts to protect against harm, for example, signs, barriers, painting stairs yellow or orange, and otherwise warning of potentially dangerous conditions.

BUSINESS STRUCTURE FOR PROFESSIONAL PRACTICES

The basic legal entities of business structure are *sole proprietorship*, *partnership*, *corporation*, and *limited liability company* (LLC). A major basis for choice among these is insulation for the practitioner against claims against the entity and other

providers or employees in the practice. Note, however, that regardless of the type of practice entity, individual practitioners cannot escape liability for their own negligence or deliberate wrongful acts.

APPARENT AGENCY

Although individuals may not be actual partners, stockholders of a corporate entity, or members of an LLC, if they represent to the world that they are in some way connected in practice, the law provides that they may be liable for a nonpartner's negligent or intentional act that harms another. This apparent agency can be formed by poor planning in signage, information, and clarification of the independence of each professional working or having an office in a particular location. It is suggested that sole practitioners who share practice space make sure that clients and the world at large be informed that they are not partners but a group of independent professionals sharing space.

This chapter is meant to inform practitioners generally. Reading this chapter must not be considered to be in lieu of securing competent legal and financial advice and assistance from an attorney and an accountant licensed to practice in the state in which you will be practicing, with specialized experience or training in matters related to mental health and human services law, ethics, and practice.

This caveat having been stated, this chapter provides practitioners with an overview of the benefits and differences of practicing under the four primary distinct forms of the practice entity.

SOLE PROPRIETORSHIP

The oldest, most common, and simplest form of business organization is a sole proprietorship—a business entity owned and managed by one person. It is often organized very informally, is not subject to much federal or state regulation, and is relatively simple to manage and control. The owner and business are one entity, inseparable from each other. The owner has complete control over the business and its operations and is financially and legally responsible for all legal and ethical obligations of the business. Taxes on a sole proprietorship are determined at the personal income tax rate of the owner; a sole proprietorship does not pay taxes separately from the owner.

A sole proprietorship may be a good business organization for an individual starting a business that will remain small, does not have great exposure to liability, and does not justify the expenses of incorporating and ongoing corporate formalities.

Because there is one owner of the business practice, there are no formalities for creating a sole proprietorship, and it is the simplest form of business to create. The owner manages and controls the practice, may use all business profits, solely carries losses, and can generally deduct losses from other income for tax purposes.

The owner may sell the practice assets in entirety or in part. The business does not file or pay taxes—all income is attributed to the owner, and all profits and losses of the practice are reported directly to the owner's income tax return. On the downside, the owner could spend unlimited amount of time responding to business needs, cutting into his or her availability for practice.

The owner faces unlimited personal liability for debts of or claims against the practice, and if he or she is the only professional practicing in the business, liability insurance is of limited or no help. Capital financing may be very difficult for sole proprietors. Except for his or her own capital or contributions by others, capital must be obtained from the owner or through loans based on owner's creditworthiness. Because a sole proprietorship is not a separate legal entity, it ordinarily terminates when the owner becomes disabled, retires, or dies. As a result, the sole proprietorship lacks continuity and does not have perpetual existence like other business organizations. However, a sole proprietorship is an asset (or liability if it is encumbered by debt or other claims against it), the *value of which* will be subject to division in the case of divorce of the owner, in accordance with state law. It may also pass to heirs on the death of the owner and sold to a member of the decedent's profession.

PARTNERSHIPS

GENERAL PARTNERSHIP

A general partnership is "an association of two or more persons to carry on as co-owners a business for profit [. . .]." In other words, if two or more individuals do nothing more than verbally agree to conduct business as owners, a general partnership is formed. Partnerships consist of relationships between two or more persons embodied in an agreement. Creation of the agreement establishes rights and duties between the partners and regulates their conduct as they transact business. The duration of a partnership and the transfer of ownership shares is determined by agreement of the partners or on occurrence of certain events identified by state law. While a general partnership may be created by a verbal agreement, it is customary and highly recommended that the partners define their rights and duties in a written agreement.

Sources of partnership law are many. Much of this law has been codified in state statutes. Even where no statutory filing is needed to form and operate a partnership, such statutes can also be useful references in developing a contract creating and defining the relationship between partners when the partnership agreement is silent on a particular topic.

There are few legal requirements to creating a partnership. Partners may pool their resources and talents. This allows all partners share control and participate equally in management of the partnership unless otherwise agreed upon by contract. A general partnership has "flow-through taxation": The partnership entity does not pay taxes, but the individual partners are taxed on the income they

receive from the partnership. All partners are jointly and severally liable for all obligations.

Profits, losses, and distributions are divided among partners in any manner they choose, consistent with the partnership agreement or, absent an agreement, according to state law. Under a general partnership, assets of any of the partners are vulnerable to the business liabilities regardless of which partner incurred the liability. Partners have unlimited personal liability in a partnership form of business—not only for their own actions, but also for the actions of their partners. Therefore, a written partnership agreement setting out the responsibilities of the partners to each other is extremely important. It is strongly recommended that the partnership agreement be prepared by an attorney who represents all of the proposed partners—one who has no loyalty to or interest in any one or group of potential partners.

LIMITED PARTNERSHIPS

Some states permit limited partnerships. Since this is a fairly new concept, recourse must be had to local state law, and professional advice is extremely important. Formation of the entity requires filing of documents to the relevant state registration office and usually requires a written limited partnership agreement.

Generally, a limited partnership is an entity having one or more general partners and one or more limited partners. It is formed under state law by two or more persons or entities, subject to a state statute. A limited partnership is a separate entity distinct from its partners and must include both *general partners* and *limited partners* and provides both limited liability and partnership protections. As with a general partnership, the partnership agreement governs relations among the partners and between the partners and the partnership. A limited partnership may sue, be sued, defend in its own name, and maintain an action against a partner for harm caused to the limited partnership by a breach of the partnership agreement or violation of a duty to the partnership.

General partners have management control, share the profits pursuant to agreement, and have joint and several liability for partnership debts. As agents of the partnership, they have the authority to bind all the other partners in contracts with third parties that are in the general course of the firm's business.

Limited partners have no management authority and unless they have been held out to others as agents of the firm, they have no inherent agency authority to bind it. Their individual liability for the firm's debts is limited to the extent of their registered investment. They are paid a return on their investment, similar to a corporate dividend, as provided by the partnership agreement.

CORPORATIONS

The business corporation is the most complex form of business organization. A for-profit corporation is an association of individuals created by law with

powers and liabilities independent of its stockholders. It is a “legal person,” an entity separate and distinct from the people who control, manage, and own it, and it is governed by its articles of incorporation and bylaws. As a separate legal entity, the corporation can do business, owns the corporate property, owes the corporate debt, and is the debtor that gets sued or the creditor or claimant who sues. The day-to-day management of a corporation is usually done through a board of directors and officers, who are usually elected by the corporation’s stockholders.

There are routine formalities a corporation must follow on pain of serious consequences, including denial to recognize the company as a corporation. These include adequate investment of money (capitalization) in the corporation, formal issuance of stocks to the initial shareholders, and upkeep and update of business records and transactions separate from those of the owners. Assuming the board of directors and shareholders comply with such corporate formalities as holding board meetings and paying franchise taxes and related obligations, a corporation largely insulates its shareholders from individual civil liability for acts and omissions of the business and its personnel. Stockholder status does not, however, insulate a professional from individual liability as an employee or contractor of a corporation. This reality requires that each professional have individual professional liability insurance or that, by contract, the corporation is required to maintain such on behalf of the professional.

With certain important exceptions, owners of a corporation have *limited liability* for corporate obligations—they are not personally liable for debts incurred by the corporation and cannot be sued individually for corporate wrongdoings. There are, however, circumstances under which this limited liability will not protect the owner’s personal assets, including a court ruling that the corporation ceases to exist as a result of failure to adhere to the corporate formalities.

A stockholder will be held *personally liable* if he or she treats the corporation as an extension of his or her personal property, rather than a separate entity; personally injures someone; has personally guaranteed a loan or a business debt for the corporation that the corporation fails to repay; fails to deposit taxes that have been deducted from the employee wages by the corporation; or is part of intentional fraud or other illegal action that results in loss to the corporation or someone else.

Corporations are formed under the provisions of each state’s business or professional corporations acts. The process of incorporation requires the filing of articles of incorporation, providing information to the state’s registration authority. The information ordinarily identifies the incorporators (the individuals who form the corporation); the number of shares and type of stock to be authorized and issued; the rights, duties, and financial obligations attributable to stock owners; the distribution of corporate assets should the corporation dissolve; the value attributed to the assets of the corporation; the names of the initial corporate directors and officers; and an agent to receive service of process in the event of a lawsuit or administrative action on behalf of the corporation.

Generally, there are two types of corporate structures. A *closely held corporation* is one in which there are a small number of shareholders who own the corporation's shares, share transfer restrictions are likely, and the owners of the corporation are usually the board members and officers who also work for the corporation. A *publicly held corporation*, in contrast, has shareholders who are part of the general public, demand for the corporation's shares is much broader, there are generally no share transfer restrictions, and shareholders are not exclusively board members and officers.

BUSINESS CORPORATIONS

Under the Internal Revenue Code, corporations may have a designation as a "C" corporation or an "S" corporation."

C Corporation A C corporation is taxed separately from its owners. It is owned by shareholders, who must elect a board of directors that make business decisions and oversee policies. It must file its own income tax return and may have different rules in regard to depreciation of assets, payment of taxes, capital gains, and income and related tax matters. The profit of a C corporation is taxed to the corporation when earned, and then taxed to the shareholders when distributed as dividends. Thus, profits are double taxed. A C corporation cannot deduct dividends paid to shareholders but may deduct expenses such as payroll. Shareholders cannot deduct corporate losses. In most cases, a C corporation is required to report its financial operations to the state in which it is organized. As an independent legal entity, the corporation does not cease to exist when its owners or shareholders change or die.

S Corporation A corporation that functions as a subchapter S corporation allows the shareholders the protection of limited liability, as well as some appealing tax benefits. One of the clearest benefits is that the owners of an S corporation pay taxes only once and through the shareholders' individual income tax returns. With subchapter S status, a corporation may elect to have flow-through taxation as if it were a partnership—that is, income and losses are passed through to shareholders and included on their individual tax returns. As a result, there is only one level of federal tax to pay. The specific requirements and benefits of this tax designation should be discussed with your accountant or tax preparer. To elect S status, the corporation must do so no later than the 15th day of the third month of the tax year for which the election is intended to be effective, or any time in the preceding year.

There are membership requirements for S corporation status: Only a domestic corporation may qualify, and there are restrictions on who can be members. There may be no more than 100 shareholders, who may be individuals, certain trusts, and estates, but not partnerships, corporations, or nonresident alien shareholders. An S corporation may have only one class of stock and must follow the same

requirements that C corporations must follow—filing articles of incorporation and state-required periodic reports, holding directors’ and shareholders’ meetings, keeping corporate minutes, and permitting shareholders to vote on major corporate decisions.

States differ in their treatment of S corporations. Some totally disregard S status and give them no tax break. Other states automatically honor the federal election. A special, state-specific form may be required for election. Consultation with an attorney in the corporation’s state is a *must*.

NONPROFIT CORPORATIONS

There are three basic types of nonprofit corporations: public benefit, mutual benefit, and religious. Public benefit corporations are the charitable nonprofit corporations and qualify as tax exempt by section 501(c)(3) of the Internal Revenue Code. Mutual benefit corporations are corporations that are not public benefit or religious corporations. Examples include fraternal organizations, homeowners’ associations, and country clubs. Religious corporations are corporations organized primarily or exclusively for religious purposes.

To be tax-exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in that section, and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization—it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates. Section 501(c)(3) organizations are restricted in the amount of how many lobbying activities they may conduct. If the organization engages in an excess benefit transaction with a person having substantial influence over the organization, an excise tax may be imposed on the person and any organization managers agreeing to the transaction.

PROFESSIONAL CORPORATIONS

A professional corporation (PC) is a business organization that allows professionals to practice in an association of individuals and offers many of the benefits of a for-profit corporation. A PC may elect subchapter S status. Its name may not be one already be in use by another business entity on record with the state. It must be organized for the sole purpose of rendering a designated professional service and may be formed only by the eligible professionals identified in state law. All shareholders in the corporation must be licensed to render the specific professional service of the corporation. For example, in a psychology corporation, all the shareholders must be licensed psychologists.

Unless the articles of organization specify otherwise, the liability of shareholders in a professional corporation is limited in the same manner and to the same

extent as that of a for-profit business corporation. Ordinarily, a state's professional corporation act does not modify the duty of care owed to a person receiving services from a professional practicing in a professional corporation. In other words, professionals practicing in a professional corporation remain liable for their own malpractice. Some states, however, may provide for exceptions.

There is a significant limitation on personal liability in a professional corporation. While the corporation cannot protect the shareholder professionals against their own negligence, it does protect them against the negligence of each other. Thus, professional incorporation is a useful backup to professional liability insurance.

LIMITED LIABILITY COMPANY (LLC)

The limited liability company (LLC) is a recently recognized business structure allowed by state statute. This popular new concept shares the corporate feature of limited personal liability of *members* (owners) for the debts and actions of the entity, and provides management flexibility and the benefit of pass-through taxation. However, the LLC also allows owners to benefit from many of the features of a partnership by providing management flexibility and the benefit of pass-through taxation (not unlike a subchapter S corporation). There is no maximum number of members. As with a sole proprietorship or partnership, there is little if any insulation protecting the personal assets of an LLC's members from a judgment resulting from a member's wrong doing in the scope and course of LLC activities.

Because the federal government does not recognize the LLC as a classification for federal tax purposes, such entity must file a corporation, partnership, or sole proprietorship tax return. Over the years, there has been confusion regarding single-member LLCs in general and how they must report and pay employment taxes. A multimember LLC can elect to be classified as either a partnership or a C or S corporation; if it does not so elect, it will be classified for tax purposes as a partnership. A single-member LLC (SMLLC) can elect classification as a corporation or, failing such election, will be automatically classified as a "disregarded entity" and taxed as a sole proprietorship. If 50% or more of the capital and profit interests of an LLC are sold or exchanged within a 12-month period, the LLC will terminate for federal tax purposes.

Employment tax and certain excise tax requirements for a disregarded entity SMLLC have changed over recent years.

Earnings of most members of an LLC are generally subject to self-employment tax. If, however, the company elects S corporation status, earnings of the entity after paying a reasonable salary to the shareholders working in the business can be passed through as distributions of profits and are not subject to self-employment taxes.

There is a lack of uniformity among LLC state statutes. Businesses that operate in more than one state may not receive consistent treatment. In order to be treated as a partnership, an LLC must have at least two members. An S corporation can

have one shareholder. Although all states allow SMLLCs, such entities may not elect partnership classification for federal tax purposes. Some states do not tax partnerships but do tax LLCs. Conversion of an existing business to LLC status could result in tax recognition on appreciated assets. Current federal and state law must be examined to determine what is best for the entity.

CONCLUSION

Regardless of one's practice or whether one practices from a bar, a rented office, in a self-owned building, or as an independent contractor for an agency, hospital, or other entity, making the correct choice of practice entity is imperative to reduce potential financial liability. Although a professional cannot protect him- or herself from allegations of professional misconduct or intentional or negligent deviation from the standard of care of the reasonable professional under the circumstances, a corporation can provide insulation to protect your personal finances and that of your family from being attached as a result of an injury, breach of contract, and many other potential liability situations. It is advised that for the minimal cost associated with establishing and maintaining a corporation or LLC, organization of a professional as an entity offering some insulation from personal liability is well worth the expense. The decision must be made having advice of an attorney who is familiar with mental health and human services law and after having discussed in the limits imposed on corporate or LLC entities by individual states' regulatory departments. The bottom-line financials, tax benefits, and the like must also be discussed with your tax preparer or accountant aware of the professional obligations, criteria, and restrictions of licensed individuals.