BUSINESS ORGANIZATIONS FOR LAWYERS AND LAW FIRMS

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Introduction

Oklahoma lawyers today have a wide range of entities through which they may practice. In addition to the historical choices of sole proprietorships and partnerships, Oklahoma lawyers may practice through corporations (either C or S corporations), limited liability companies or limited liability partnerships. Each entity has unique characteristics, which pose advantages and disadvantages. This paper will examine the advantages and disadvantages of these entities to provide a basis on which lawyers may make informed decisions about what entity is right for them.

Historical Background

In 1961, Oklahoma adopted its Professional Corporation Act.[1] The act's adoption resulted from two developments: first, a recognition that limited liability does not impair the traditional professional relationship between a lawyer and the client, and second, a desire by professionals to gain rather substantial income tax advantages that were then available only to corporations. Regarding the first development, professionals were long denied the use of corporations due to a belief that the corporation's limited liability was incompatible with the professional relationship.[2] The belief does not withstand examination. The professional relationship is grounded in the duties that a lawyer owes a client. If a lawyer breaches a duty, he or she is liable regardless of the presence of a professional corporation. In other words, a corporation's limited liability offers no protection from an individual's breach of duty. The individual is personally liable whether he or she practices as a sole proprietorship or through a corporation.

The desire for corporate tax advantages was a second incentive for professional corporations.[3] At the time, the Internal Revenue Code permitted generous deductions for qualified retirement program contributions by corporations. These deductions were not available to sole proprietorships or partnerships. The disparity has since been eliminated,[4] but the advantage was for many years a powerful economic incentive to become a professional corporation.

As an alternative to sole proprietorships or partnerships, the professional corporation stood professionals in good stead for many years. They were not, however, the preferable answer for all professionals. To avoid the double taxation of C corporations, professionals had to pay out annually as compensation all money that

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[1]Okla.Stat. tit. 18, §§801-19.

[2] *See* Johnson, Jennifer J., *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 Bus. Law. 85, 92-102 (Nov. 1995).

[3] *See gen.*, Note, *The Taxation of Professional Corporations and Associations*, 75 Harv.L.Rev. 776 (1962).

[4]Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §238.

would otherwise be taxed as income, thus penalizing capital accumulations. An S corporation election could avoid double taxation, but posed other tax complexities □ such as restrictions on the number of shareholders and classes of stock □which limited its utility for professionals. Moreover, statutory restrictions for professional corporations typically limited ownership and management to resident professionals, which in turn curbed interstate practices. These disadvantages were not present in partnerships, which continued to be a viable choice of entity for many professionals despite the absence of limited liability.

The advent of professional LLCs ("*PLLCs*") and LLPs offered professionals the advantages of both "pass through" partnership taxation and corporate-style, limited liability. In concept, the LLCs and LLPs seemed to be the perfect choice of entity. The choice was even strengthened when in 1997 the Internal Revenue Service adopted the socalled "Check-the-Box" regulations, which permit one to elect either partnership or corporate taxation.[5] The regulations thus eliminated the old partnership classification tests, which imposed restrictions on the transferability of interests and dissolution upon a member's dissociation. Another benefit of the regulations was the recognition of single member LLCs.

Is then the LLC or LLP the perfect choice for professionals? Preferable perhaps, but not perfect. While LLCs are the presumptive choice for most small businesses, in the rather narrow circumstances of professional services, corporations (or PLLCs) electing taxation under Subchapter S of the Internal Revenue Code still enjoy some advantages that must be explored. In short, no definitive answer can be given as to which entity is the best. The choice will depend on the individual circumstances in which a professional practices.

Characteristics of the Professional Entity

Entities under the Oklahoma Professional Entity Act

The Professional Entity Act (formerly the Professional Corporation Act) authorizes professional practice through corporations, LLCs and limited partnerships.[6]

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[5] Treas. Reg. §§301.7701-1 to 7701-3c. The Check-the-Box regulations provide that unincorporated entities (primarily LLCs, partnerships and limited partnerships) with two or more members will be taxed as partnerships unless the entities affirmatively elect to be taxed as corporations. Single member, unincorporated entities (such as LLCs) will be disregarded for tax purposes (sole proprietorships, if individually owned, and divisions, if corporately owned) unless they affirmatively elect to be taxed as corporations. Federal, state or tribal law corporations, banks, insurance companies, publicly-traded entities and certain foreign entities will be taxed as corporations and cannot otherwise elect. Taxation of non-profit entities is unchanged.

[6] Okla.Stat. tit. 18, §§801-19. Until the absence of control test is eliminated for limited partners, the limited partnership will not likely be a viable entity for professional practice, and this paper does not include consideration of its merits. Oklahoma professionals may also use LLPs. *See* Okla. Stat. Ann. tit. 54, §1-1001(a). For a general discussion of PLLCs, see

The act restricts ownership and management to licensed professionals to prevent unauthorized practice by non-professionals. Persons not licensed under Oklahoma law are prohibited from owning interests in or managing the professional entity. A professional's disqualification to practice is deemed a withdrawal from the entity under the LLC Act or under RULPA, which results in a termination of the professional's interest.[7]

Entities not under the Oklahoma Professional Entity Act

The Professional Entity Act does not regulate the traditional sole proprietorship or partnership or the LLP, which is a form of general partnership. These entities are subject to the various regulations applicable to the rendering of professional services. For lawyers the regulations are the Rules of Professional Conduct, which among other things regulate practice with non-licensed individuals, the responsibilities of a partner or supervisory lawyer, the sale of a practice, advertising, and the use of non-compete agreements.[8]

Characteristics of Professional Corporations

General. Corporations are owned by shareholders among whom the corporation's capital is divided through the ownership of shares of capital stock. At least in theory, the share interest is freely transferable (to other licensed professionals), and the corporation is a separate legal entity independent of its shareholders. Under the statutory scheme, the shareholder/professionals are not active participants in management – except for their

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Keatinge, Coleman, Donn and Hester, *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 Bus.Law. 147, 180-193 (Nov. 1995) ("*Keatinge, Coleman, Donn and Hester*").

[7] Okla.Stat. tit. 18, §812. While a PLLC or limited partnership will protect its professionals from liability for the contractual obligations of the entity and the misfeasance of others, it will not limit a professional's liability for his own tortious conduct or the tortious conduct of one whom the professional supervises. Whether a PLLC or limited partnership will limit a professional's vicarious liability is not squarely settled in Oklahoma. Under the apparent majority view, a professional in a professional corporation (or LLC) will not be vicariously liable for the torts of another. *See* Ann., *Liability of Professional Corporation of Lawyers, or Individual Members Thereof, for Malpractice or Other Torts of Another Member*, 39 ALR 4th 556. References in the Oklahoma Professional Entity Act to the Oklahoma General Corporation Act and the Limited Liability Company Act — under which vicarious liability clearly does not exist — suggests that professionals are protected from vicarious liability. Reference to the analogous LLP laws —under which vicarious liability clearly does not exist either —further suggests that professionals are protected from vicarious liability in any limited liability entity. Others argue that *American National Bank v. Clarke & VanWagner*, 692 P.2d 61 (Okl. App. 1984), which upheld claims against two professionals in a professional corporation for return of excessive legal fees, suggest that professionals will be vicariously liable in Oklahoma. The case is not decisive, however, since the court found that both

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Sargent, Mark A. and Walter D. Schwidetzky, *Limited Liability Company Handbook*, §1.4 (Clark Boardman Callaghan 2016-17 ed.) ("*Sargent and Schwidetzky*"); regarding LLPs, *see* lawyers were involved in the case that produced the excessive fees and thus were directly, not vicariously, liable for return of the excessive fees.

[8] *See gen.*, Okla.Stat., tit. 5, Ch. 1, App. 3-A. While certain rules apply only to sole proprietorships or partnerships, most of the rules apply equally to professional corporations and PLLCs.

rights to elect directors and to approve extraordinary transactions – and are protected from personal liability for the acts or omissions of the corporation. The directors are collectively responsible for management of the corporation's business, but may not act individually. The directors appoint officers who conduct the day-to-day business of the corporation and act individually on the corporation's behalf. The directors and officers are bound by fiduciary duties of care and loyalty to act in the best interests of the corporation.

When employed by professionals, the corporate model may function somewhat differently. The standard corporate model presumes that the shareholders, directors and officers are not necessarily the same individuals, and thus imposes various checks and balances on their respective roles. In professional service corporations, especially smaller corporations, each shareholder is often also a director and an officer. In these instances, the professional corporate model begins to look more like the partnership model, in which each partner is empowered with equal authority.

The C Corp. Corporations are taxed by default under Subchapter C of the Internal Revenue Code ("*C corps*"). A C corp begins its existence by filing its certificate of incorporation, and completes its organization by issuing shares, electing directors and officers, and adopting its bylaws. Incorporation is tax-free if the control tests are met under the Internal Revenue Code.[7] The income and gain that it subsequently generates is taxed at the corporate level. If distributions are subsequently made to the shareholders, the shareholders are taxed on the value of the distributions. A C corp may merge with other corporations on a tax-free basis. When it winds up its affairs, any gain will also be taxed at the corporate level and again at the shareholder level when distributed.

The S corp. Qualifying corporations can elect taxation under Subchapter S of the Internal Revenue Code ("*S corps*").[8] These S corps are identical to C corps for state law purposes. The distinction arises from its pass through tax treatment. Under Subchapter S, income is not taxed at the corporate level and the corporation's income and loss pass through to be taxed at the shareholder level. Thus, the S corp avoids the double taxation of the C corp.

S corp taxation is not, however, the same as partnership taxation. The taxation of S corps retains some C corp treatments. For example, the formation and dissolution of S corps may be taxable events, which are not recognized in the formation or dissolution of

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[7] I.R.C. §351 (requiring that the shareholders forming the corporation retain at least 80% control after formation).

[8] *Id*., §1361 et seq.

partnerships. This creates the possibility that a contribution or distribution of appreciated property by or to an S corp shareholder will be taxed, although a like contribution by or distribution to a partner would not be taxed.[9] An S corp shareholder must pay the fair market value of any stock he or she receives, while no such requirement exists for partnerships.[10][11] A partnership permits certain basis adjustments that are not allowed in an S corp.[13] In a partnership, its liabilities will proportionately increase each partner's basis if no partner is personally liable for the liabilities.[12] If a partner's interest is transferred, the new partner may increase his or her basis by the amount of the appreciated assets in the partnership.[13] The S corp does not offer these possible advantages.

In exchange for its pass through tax treatment, an S corp bears several restrictions. The restrictions limit the authorized stock to a single class (although voting rights may differ within the class), and all distributions must follow the stock ownership. Most shareholders must be U.S. citizens, resident aliens, estates, or certain trusts and the number of shareholders is capped at 100.[14] While restrictions on the number and identity of shareholders will not affect most professional corporation, the inability to allocate disproportionate shares of income and loss can be a significant disadvantage for many professionals.

Characteristics of PLLCs

Oklahoma adopted its LLC Act[15] in 1992 and made the PLLC available to professionals in 1995.[16] LLCs resemble a hybrid cross between a corporation and a

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[9] The distinction is particularly important when the entity repurchases a departing professional's interest. In both LLCs and S corps, professionals may provide contractual buyout rights. In an LLC, the payments made to purchase the member's interest may be treated as liquidating payments, which may be made with pre-tax dollars. *See* I.R.C. §736.

[10] In a partnership, a partner may receive a profits interest in exchange for future services without the immediate recognition of income. Rev. Proc. 93-27 and 2001-43. If the S corp shareholder pays less than the fair market value of the shares received, he or she will recognize the shortfall as income.

[11] *See gen.*, Sargent and Schwidetzky, *supra* note 6, at §3.3. These basis adjustment provisions would themselves offer a compelling advantage to LLC's over S corps. The advantage is, however, limited by the "at risk" and passive loss limitations under the Internal Revenue Code. I.R.C. §§465 and 469. The partnership tax rules also insure that built-in gain or loss attributable to contributed property will be allocated to the contributing partner. In an S corp, the gain or loss will be spread among all the shareholders.

[12] I.R.C. §752(a).

[13] *Id.* at §743(b).

[14] *Id.* at §1361; Treas. Reg. §1.1361-1.

[15] The Oklahoma Limited Liability Act, Okla.Stat. tit. 18, §2000-2060 (the "*LLC Act*").

[16] *Id.* at §§801-19.

partnership. Like a corporation, they afford limited liability to all owners (called members instead of shareholders). They may be governed by non-owner managers (called managers instead of directors or officers). Their legal existence is recognized by the State upon the filing of a notice (called articles of organization instead of a certificate of incorporation) and is terminated in the same manner.

Unless they elect corporate taxation (either C or S corp), LLCs are like partnerships for income tax purposes.[19] All income, gain, loss, deduction, and credit pass through the entity to its members. There is no entity-level taxation as in corporations. LLCs are flexible in operation. They may be structured like partnerships with equal ownership and management rights. They may be structures like corporations with a board of managers, officers and largely passive owners. The dissociation of a member will not terminate the LLC. An LLC may be owned by a single member. An LLC may elect to be taxed as a corporation (C corp or S corp) at the election of its members.[20]

Characteristics of Professional LLPs

LLPs are general partnerships with limited liability, and thus resemble LLC's by combining limited liability with partnership taxation. The LLP provisions are found within Oklahoma's Revised Uniform Partnership Act ("RUPA").[17]

Subclass of General Partnership. Unlike the LLC, which is a unique form of entity, the LLP is merely a subclass of general partnership.[22] Its distinction among

[19] An LLC owned by one member and not electing corporate taxation is disregarded for Federal income tax purposes. T.D. 8697 (1997-1 C.B. 215) and Treas. Reg. §§301.7701-1 to 301.7701-3c.

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[17] The first Oklahoma LLP Act was enacted as Okla.Stat. tit. 54, §§401-407. RUPA is enacted as Okla.Stat. tit. 54, §§1-100 - 1-1207. RUPA replaced the 1916 Uniform Partnership Act (*id*. at §§201-243). The main LLP provisions are found in §§1-306(c)(liability limitation) and 1309 (security for payment) and Articles 10 (limited liability partnerships) and 11 (foreign limited liability partnerships). The paper will refer to the LLP provisions within RUPA as the LLP laws.

The notion of an LLP originated in Texas. Within the 1991 legislation adopting Texas's limited liability company act were brief provisions permitting a Texas general partnership to limit the vicarious tort liability of its partners by a notice filing with the Texas Secretary of State. The concept was relatively simple. The authorizing legislation merely described the filing requirements and the nature of the liability limitation. The LLP's method of operation was left to the Texas general partnership act. Although Texas LLPs were not restricted to use by professionals, professionals □many of whom were operating as partnerships □found the concept extremely attractive. While widely recognized, professional corporations or LLCs were not universally recognized. General partnerships were. For professionals with interstate practices, particularly the large accounting firms, the prospect of securing limited liability in a general partnership was worth pursuing. The American Institute of Certified Public Accountants undertook a nation-wide lobbying effort to secure passage of LLP legislation, and their lobbying efforts enjoyed considerable success. Like the LLC, the LLP has proven

[20] In some respects, an LLC may be a better corporation than a corporation. The possible advantages include the elimination of statutory dissenter's rights, no quorum and voting requirements, and no par value restrictions on subscriptions and distributions. The judgment creditor of an LLC member cannot attach the LLC interest, but has only a charging order. In a corporation, the judgment creditor can attach the shareholder's stock. A corporate LLC will avoid the Oklahoma restrictions on rural land ownership and the restrictions on permitted consideration for stock. A corporate LLCs will avoid the state franchise taxes and annual reporting applicable to statutory corporations, although it must file its annual report and pay the annual $25 fee. *See* Derrick, Gary W., *Oklahoma Limited Liability Companies and Limited Liability Partnerships*, Okla. City Univ. L. Rev. 643, 667 (Summer 1997).

general partnerships is that the LLP partners have corporate-style, limited liability. The LLP obtains this protection by (i) securing the partners' consent to become an LLP,[23] (ii) filing a notice with the Oklahoma Secretary of State, and (iii) posting security or obtaining insurance for potential claims made against it.

Apart from limited liability, the LLP is like any other general partnership. The LLP is formed as any other general partnership, that is, when its partners intend its formation. The notice filing with the Secretary of State is irrelevant to its formation. Thus, any general partnership regardless of when formed can become an LLP (or cease to be an LLP) and its status as a general partnership is not affected.

RUPA governs the LLPs operations, including the existence and dissolution of the LLP, the authority of partners to bind the LLP, and the fiduciary relationship of its partners with one another. Much of the LLPs attractiveness as a choice of entity lies in its reliance on RUPA and the security of a well-developed body of partnership caselaw.

The Limited Liability of LLPs Broad Scope. The limited liability of LLPs is like that of corporations or LLCs. The LLP partners are personally liable for their own misconduct. They are not liable for the LLP's torts or contractual obligations.[24] The statute also makes clear that the liability limitation cannot be circumvented through a partner's contribution or indemnification obligations.

The application of limited liability to general partnerships raises several issues.[25] RUPA does not address a partner's liability for distributions made in breach of the partnership agreement or during insolvency. If a negligence claim affecting the negligent or responsible partners threatens the solvency of the LLP, can the LLP continue to make distributions to the non-negligent partners? If such distribution is wrongful, does it matter whether the non-negligent partners knew that the distribution was wrongful? Are those who approved the wrongful distribution liable also? If the LLP would be solvent but for the claim, does the cessation of distributions to non-negligent partners make them indirectly liable?[26]

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popular and is recognized in some form in all states. *See* Keatinge, Coleman, Donn and Hester, *supra* note 6, at 180-193.

[22] Okla.Stat. tit. 54, §1-201(b) (an LLP continues to be the same entity that exited before the filing of the statement of qualification) and §1-1001(a) (an LLP is a partnership).

[23] *Id*., §1-1001(b) requires a partner vote to approve the filing of a statement of qualification to become an LLP. The required vote is generally the vote necessary to amend the partnership agreement. If no amendment provisions exist, the vote must be unanimous. If the partnership agreement has a provision that specifically addresses amendments affecting the contribution obligations of the partners, then the vote set forth in that provision is required. The latter conclusion results from the effect of limited liability on partner contribution obligations.

[24] *Id*., §1-306(c).

[25] A detailed discussion of these issues is found in Keatinge, Coleman, Donn and Hester, *supra* note 6, at 180-193.

[26] These issues surfaced in the much-publicized bankruptcy of Dewey & LeBoef LLP, a large New York law firm. The bankruptcy judge ruled that the partners must repay the distributions received when the firm was insolvent. In doing so, the judge rejected the partners' argument

Stacking issues may also arise when different partners have different liabilities. Partners may be jointly and severally liable for obligations arising before LLP registration. After registration, negligent or responsible partners will be liable for the claims against them. If the LLP assets are insufficient to pay all claims, may the nonnegligent partners apply the LLP assets to satisfy the pre-registration claims while postregistration negligence claims are left to the negligent partners?[27]

The traditional contribution and indemnity arrangements in partnerships also raise issues. Under RUPA, a partner is required to contribute amounts sufficient to satisfy partnership obligations and the partnership is required to indemnify a partner for personal liabilities incurred in the partnership's business.[28] In the typical partnership, when a partner is found negligent, the partnership would indemnify him or her against losses, and if the partnership lacked sufficient assets to pay the claim, all partners would contribute amounts sufficient to satisfy the claim. Under the LLP laws, however, nonnegligent partners are not liable under contribution or indemnity provisions for claims against negligent partners. Thus, unless their partnership agreement otherwise provides, partners will sacrifice the indemnity and contribution protections afforded under RUPA in exchange for vicarious liability protection when the partnership becomes an LLP. [29]

Special Requirements of the LLP Laws Security for Claims. The LLP laws require that both Oklahoma and foreign LLPs provide security for claims arising from the acts or omissions of its partners. Failure to provide security, results in the loss of limited

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that the distributions were exchanged for the "reasonably equivalent value" of their services. *See* 2014 WL 5463302 (Bankr. S.D.N.Y. Oct. 29, 2014).

[27] Partnership obligations under a note, contract, or other agreement generally are incurred when the agreement is made. An amendment, modification, extension or renewal of the agreement should not affect or otherwise reset the time at which a partnership obligation is incurred, even if the claim relates to the subject matter of the amendment. Partnership obligations relating to a tort generally are incurred when the tortuous conduct occurs rather than at the time of the actual injury or harm. This interpretation prevents a culpable partnership from engaging in wrongful conduct and then filing a statement of qualification to sever vicarious responsibility

of its partners for future injury or harm caused by conduct that occurred prior to the filing. *See* Comments to Section 306(c) To Uniform Partnership Act (1997)(last amended 2013), National Conference of Commissioners on Uniform State Laws.

[28] Okla.Stat. tit. 54, §1-401(c). The indemnification obligation requires the partnership to indemnify a partner for losses incurred in the ordinary course of the partnership's business, even if the losses arise from the partner's negligence.

[29] In effect, each partner assumes the risk that he or she will not become a negligent partner. The result has been described as a change from a "all for one" relationship to "every man for himself." *See* Keatinge, Coleman, Donn and Hester, *supra* note 6, at 188. Many partnership agreements provide that the partners shall contribute amounts sufficient to satisfy partnership obligations. These provisions are inconsistent with the LLPs notion of limited liability. When becoming an LLP, the contribution provisions should be amended to fix a partner's contribution obligation at a sum certain, in much the same way as a shareholder has a sum certain that he or she pays for stock. If such provisions are not amended with the LLP filing is made, each partner may become jointly and severally liable for all partnership obligations regardless of LLP status.

liability.[18] Security can be in the form of insurance, escrowed funds, letter of credit or surety bonds. The amount must be at least $500,000. Insurance policies may be on a claims-made or occurrence basis, may contain customary terms, conditions and exclusions, and may have a deductible amount not to exceed ten percent of the policy amount. If the policy is impaired or exhausted due to the payment of claims, the LLP need not restore the former amount during the policy period. If security is provided in the form of escrowed funds, letters of credit or bonds, the LLP must restore any depletions below the $500,000 level within six months of such depletion.

The security provisions provide that an LLP is in compliance if it obtains the requisite security within 30 days of service of process. If the LLP is in compliance when a bankruptcy proceeding is commenced, the LLP will remain in compliance during the pendency of the proceeding. The provisions also state that applicable Federal or state law will govern the discoverability or admissibility of evidence relating to the existence or amount of security.

LLPs Under RUPA. The adoption of RUPA refines the nature and operation of general partnerships, including LLPs. These refinements include: (i) an entity versus an aggregate owner concept; (ii) the separation of dissociation from dissolution; (iii) the possibility of public filings for partner authority, dissociation and dissolution; (iv) simplified transfers of property; (v) authorization of mergers and conversions; and (vi) clarification of the fiduciary duties among partners.

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[18] *Id.*, §1-309(g). Limited liability is lost to the extent of the difference between the security provided and $500,000. Subjecting foreign LLPs to an Oklahoma security requirement (and revoking their liability limitation for failure to comply) is inconsistent with the stated intent that the laws of the state of formation shall govern the liability of the partners. Compare §1106 (Oklahoma law shall cover Oklahoma LLPs) and §1-1101(a) (foreign laws shall govern foreign LLPs). The distinction is important since many states do not impose a security requirement on LLPs and afford to LLPs the same limited liability afforded corporations and LLCs.

RUPA recognizes partnerships as entities distinct from their partners. The partnership itself has legal capacity. It doesn't change from an "old partnership" to a "new partnership" just because its ownership has changed. This recognition means that rights and duties of the partnership are not changed by changes in ownership.[19] RUPA bolsters the distinct entity concept by breaking the traditional link between a partner's dissociation and the partnership's dissolution. Under RUPA, a partner's dissociation caused the partnership's dissolution. Under RUPA, partnership having a definite term or purpose doesn't dissolve when a partner dissociates.

RUPA provides for the filing of various public statements which can indicate a partner's authority, a partner's denial of authority, a partner's dissociation or the partnership's dissolution. These statements can act as notice to third parties dealing with the partnership, especially in transfers of real property.[20] RUPA provides that partners owe duties of loyalty, due care, good faith and fair dealing. These duties are described in RUPA and may not be waived by the partners. The partnership agreement may, however, describe the standards under which these duties are to be judged if not manifestly unreasonable.[21]

The Advantages and Disadvantages of PLLCs, LLPs, PCs, Sole Proprietorships and Partnerships

The PLLC Advantages

"Pass through" Partnership Taxation In General. A multi-member PLLC is taxed like a partnership. A single member PLLC is disregarded for tax purposes. In either case, all income and loss flows through the entity to be taxed to the owner/members. Unlike a corporation, there is no entity-level taxation. As a general rule, this means that the PLLC and its members will tend to pay less income tax than a corporation and its shareholders, since the PLLC's income is not taxed once at the entity level and again at the member level.

 Special Allocations. Frequently in the PLLC (or partnership), the members will specially allocate income and costs. For example, two members practicing together may not always split everything equally. Fees paid by a particular client or on a particular matter may be allocated to one member, but not the other. A portion of the fee may be

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[19] Other provisions strengthen the separate entity concept. *See e.g.*, Okla.Stat. tit. 54, §1-307, under which the partnership may sue or be sued in its own name, a judgment against the partnership is not a judgment against the partners, and a judgment creditor must exhaust the partnership's assets before enforcing the judgment against the partners, and §1-501, which states that a partner has no transferable interest in partnership property (only transferable interest is the partner's share of profits and losses).

[20] Okla.Stat. tit. 54, §§1-303 (statement of partnership authority), 1-304 (statement of denial), 1704 (statement of dissociation), 1-805 (statement of dissolution), and 1-105 (execution, filing and recording statements).

[21] *Id.* at §§1-404 (describing duties) and 1-103 (waiver limitations).

paid to the member originating the client or matter. Costs may be charged to the member who incurred the cost or allocated to the members based on their ratable share of income. The ability to make these special allocations of income and cost is a significant advantage of PLLCs.

Corporations cannot make special allocations. In the C corp, income and costs are realized at the entity level. The shareholders can create compensation formulas that approximate the results of special allocations in PLLCs or partnerships, but these formulas (embedded in employment or shareholder agreements) can become complex and difficult to administer. S corps can do this too, if they split income between salary and distributions. The salary can be paid according to the formula, but all distributions must be made solely on the basis of stock ownership.

□ *Formation*. Formation of the PLLC will not create a taxable event. If a member contributes appreciated property, the appreciation is allocated to his or her account and is recognized only when the property is sold. In either a C or S corp, formation is tax-free only if the shareholders retain 80% or more of the stock after formation.[22] The 80% control test can pose problems when a second shareholder or group of shareholders wishes to join the corporation, but will own less than 80% of the stock. Their contribution of appreciated property would be a taxable event.

□ *Basis Step Up for Borrowings*. PLLC members and S corp shareholders may deduct company losses on their individual tax returns to the extent of basis. PLLC members may increase the basis of their membership interest when the PLLC borrows money. S corp shareholders may not increase the basis of their stock when the corporation borrows money, even if the shareholders have guaranteed the borrowings. An S corp shareholder may increase the basis of stock only by direct loans made by that shareholder to the corporation. The basis increase may be significant. A higher basis allows greater use of deductions, which reduces taxable income (an advantage). In addition, the entity can distribute cash without taxation if the distributions do not exceed an owner's basis.

□ *Adding New Members*. The PLLC has several advantages when adding new members. First, the new member is not required to buy a capital interest to get a certain income interest. In an S corp, a new shareholder joining an existing shareholder on a 50/50 basis must buy one-half of the stock to get one-half of the income, since distributable income is based on stock ownership. If the stock purchase price does not equal one-half of the net fair market value of the underlying assets, the new member will incur income to the extent of the deficiency. In the PLLC, a similarly situated, new member can receive a 50% income interest, need not pay anything, and will not be taxed on receipt of the interest.

Second, if a new member buys an interest (including a partial interest) from an existing member, the PLLC may elect to increase the basis of its assets. As noted above, a basis increase allows greater use of deductions (such as from equipment depreciation),

[22] I.R.C. §§351 and 368(c).

which decreases taxable income, and can shelter cash distributions if the distributions do not exceed the tax basis.

Departing Members. A PLLC can redeem a retiring or withdrawing member's interest and deduct the amount of the liquidation payment to the withdrawing member in exchange for that member's interest in the PLLCs goodwill and unrealized receivables. To the extent that a withdrawing member realizes gain in the redemption, the PLLC can increase its basis in its property, further increasing deductions and reducing taxable income. These advantages, which may be substantial, are not available to C or S corps.

Ownership of Appreciable Property. It is not uncommon for a professional entity to own real estate, which is appreciable property. In this situation, a PLLC offers an advantage of being able to distribute the appreciated property to its members without recognition of gain. A C or an S corp cannot do this. When a corporation makes an inkind distribution, gain is recognized at the corporate level in a C corp and at the shareholder level in an S corp.

Limited Liability. The PLLC members are protected from personal liability for the acts or omissions of the PLLC and its agents. All that the members risk is their invested capital. This is the same liability shield that protects corporate shareholders.

Simplicity of Operation. The LLC Act does not require annual meetings of members or managers. Neither are the members or managers required to record minutes (although minute-taking is a good practice). The only records that the PLLC must keep are copies of its articles of organization, its operating agreement, its tax returns and any financial statements, a document reflecting the members' voting rights, and the names and addresses of its members and managers.[23] The operating procedures and recordkeeping for PLLCs are much simpler than those required of corporations.

The PLLC Disadvantages

Self-Employment Income. In a PLLC, all income allocated to the members is subject to self-employment tax (the "*SE tax*"). For 2017, the first $127,200 of income is subject to the Social Security portion (12.4%) and the Medicare portion (2.9%) of the FICA (self-employment) tax. Any income beyond than that is subject to the 2.9% Medicare tax with a 0.9% increase for income exceeding $200,000 for single people and $250,000 for married people filing jointly. PLLC members do not have the option that S corp shareholders have of dividing the income between salary and distributions, the latter of which is not subject to SE tax.

This disadvantage may be less significant than it appears. The S corp must allot a reasonable salary to the shareholder/employee, which is subject to SE tax.[24] Only that

[23] Okla.Stat. tit. 18, §2010.

[24] *See David E. Watson, P.C. v. U.S.*, No. 11-1589 (8th Cir., Feb. 21, 2012); *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180; *Sean McAlary Ltd. Inc. v. Commissioner*, T.C. Summ. 2013-62; and *Radtke v. U.S.*, 712 F.Supp. 143 (E.D.Wisc., 1989) (in which the court denied an

portion of income that can be reasonably allocated to distributions avoids SE tax. In an effort to limit the SE tax disparity between partnerships (and PLLCs) and S corps, partnerships and PLLCs can deduct one-half of their SE taxes.[25]

The LLP Advantages

"Pass through" Partnership Taxation In General. Among the various professional entities with limited liability, LLPs are most like PLLCs. Each combines the benefits of single-level or partnership taxation with limited liability. The shared link to partnership taxation means that each maintains partnership-style capital accounts, operates under the same allocation and basis adjustment rules, and will likely adopt similar approaches to the admission of new professionals, the withdrawal of existing professionals, and dissolution of the entity.

Limited Liability. LLPs provide broad scope, limited liability like corporations or PLLCs. The availability of such protection is, however, contingent upon the posting of security, which is unique to LLPs. See "*LLP Disadvantages*" below. Further, if professionals in an LLP will practice in other states, one must realize that the LLP liability protection varies from state to state: some states offer broad scope protection while other states protect only against vicarious liability.

Operational Flexibility. The possibility of centralized management in a PLLC may seem to be another significant difference between PLLCs and LLPs. In practice, the difference is more theoretical than real. RUPA presumes that each partner can bind the partnership and will participate equally in the partnership's affairs.[26] But partnerships often delegate to certain partners management authority and contractually limit the authority of other partners, much like a PLLC might use managers.[27]

The LLPs basis in general partnership law provides other differences. Although PLLCs and LLPs share a like capital structure, members are presumed to share profits, losses, and distributions in proportion to their capital contributions while partners are presumed to share equally. PLLC members vote on a pro rata basis; partners vote on a per capita basis. The LLC Act has special liability provisions for unpaid contributions

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attorney/shareholder's attempt to claim all S corp income as dividends and recharacterized the income as salary).

[25] I.R.C. §164(f).

[26] Okla.Stat. tit. 54, §§209(1) and 218(e).

[27] Despite an entity's contractual arrangement for authority, if a third party with whom the member or partner is dealing lacks actual knowledge of the member's or partner's limitation, the apparent authority doctrine may bind the entity for the member's or partner's acts. To counter this result, RUPA provides for public statements of a partner's authority, a partner's dissociation and the partnerships dissolution that can under certain circumstances act as constructive notice to third parties. *See id.* at §§1-303 (statement of partnership authority regarding transfers of real property), 1-304 (statement of denial), 1-704 (statement of dissociation), and 1-805 (statement of dissolution).

and wrongful distributions,[28] which must be determined contractually in an LLP. In the absence of contrary agreement, a partner can withdraw from an LLP and force a buyout of his or her interest.[29] An LLC member has the power to withdraw, but no statutory right to withdraw. Without a contractual right, a withdrawing member cannot force a buyout of his or her interest and the member becomes an assignee of the interest after withdrawal. [30]

Discrimination Rules. Some authority holds that LLPs are excepted from the antidiscrimination rules applicable to employees since a partner is not normally considered to be an employee. This authority may still apply to smaller firms in which all partners actively participate in the firms' management. But several high profile cases have found otherwise in discrimination cases against larger law firms.[31]

The LLP Disadvantages

Formation. To file a statement of qualification, the LLP partners must amend their partnership agreement to eliminate the indemnity and contribution provisions that would otherwise apply to a general partnership.

Potential Loss of Limited Liability. As a condition to obtaining limited liability, the LLP must provide $500,000 of security against claims, either through insurance, escrowed deposits, letters of credit or surety bonds. Corporations and PLLCs have no such requirement. Other questions about liability protection may arise in the LLP such as the relationship of the protection to contribution and indemnity obligations or the priority of partnership obligations the responsibility for which differs among the partners which are not present in corporations or PLLCs.

Self-Employment Income. As in the PLLC, the LLP partner cannot divide his or her allocable income between compensation and distributions and avoid SE taxes on the latter. See "*PLLC Disadvantages*" above.

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[28] *Id.* at tit. 18, §§2024 and 2031.

[29] Under UPA, a partner could withdraw at will and receive the value of his or her capital account. The partner will not share in the partnership's goodwill. Under RUPA, unless the partnership agreement otherwise provides, a partner can withdraw at will and receive the greater of the interest's liquidation value or going concern value, unless the withdrawal is premature (occurring before the end of the partnership's term or its purpose). If the withdrawal is premature or wrongful, the withdrawing partner will receive payment only at the end of the partnership's term or purpose unless the partner demonstrates that payment will not cause undue hardship. *See id.* at tit. 54, §1-701.

[30] *Id.* at tit. 18, §2036.

[31] The issue turns on whether the partner is a *de facto* employee. *See e.g., Clackamas Gastroenterology Associates, P.C. v Wells*, 538 U.S. 440 (2003) (establishing a six-factor test); *EEOC v. Sidley Austin Brown & Wood*, 315 F.3d 696 (7th Cir. 2002) (partners are employees); *but see Solon v. Kaplan*, 398 F.3d 629 (7th Cir. 2005) (in small firm, the partner was not an employee).

The C Corp — Advantages

Limited Liability. The C corp limits the liability of its shareholders to the amount of capital they have at risk in the business. The shareholders are not liable for the obligations of the corporation.

Familiarity. Corporations have a long history and people are familiar with the operating characteristics of corporations. In addition, corporations are supported by a body of well-established law to guide their operations.

Medical Expense Deductions. When a C corp provides its employees with fringe benefits, such as health insurance, it receives a deduction for the benefit, yet the value of the benefit is not taxed to the employees. This effectively allows the benefit to go untaxed. This arrangement applies regardless of whether the employee is also a shareholder in the C corp. Because PLLC members and S corp shareholders are not "employees", somewhat different rules apply to partnerships, PLLCs and S corps. In most cases, however, PLLC members and S corp shareholders will recognize the value of their benefit as income and deduct the cost as expense.

The C Corp — Disadvantages

Double Taxation. The corporation is recognized as a separate entity for Federal and state income tax purposes. This means that income and gain is taxed both at the corporate level and when distributed to the shareholders as dividends. For personal service corporations, the Federal tax rate is 35% and the rate is not graduated.[32] Individuals are taxed at graduated rates up to 39.6%.[33] Thus, the cumulative tax on income from C corps may be over 60% before imposition of state taxes.[34]

While double taxation is certainly a disadvantage – and pass through taxation is certainly an advantage – it must be placed in the context of actual practice. Business owners everywhere tend to maximize their tax position (that is, they minimize their tax payable). In the C corp, shareholders do this by incurring additional corporate expense, which reduces taxable income. The most common example is the paying out as compensation to shareholder/employees those amounts that would otherwise be taxed as income. If the corporation pays out all such income, it achieves a partnership-type result —no income at the entity level; all income taxed to the shareholder/employee.

This practice has its price. If the C corp pays out all its income, it may deplete its capital reserves for operations. It is not unusual for shareholder/employees to go several months without compensation while the corporation replenishes its capital reserves. It

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[32] I.R.C. §1366(a).

[33] *Id*., §1.

[34] An example of the tax calculation would be: $100 times 34% leaving a balance after payment of $64, which is then taxed at 39.6%. The remaining balance is slightly less than $40. This calculation doesn't consider personal deductions and exemptions, the effect of graduated individual rates and the burden of state taxes.

can borrow cash to avoid this problem, but borrowings incur interest expense and smaller professional corporations may incur relatively high interest expense without a substantial operating history, substantial capital or shareholder guarantees. Borrowings also diminish a corporation's ability to weather lean periods. In addition, the Internal Revenue Service can recharacterize the distributions as excessive compensation and thus tax the distributions as dividends.[35]

Self-Employment Taxes. While C corp shareholder/employees are not subject to SE taxes, they may pay an equivalent amount. As employees, they pay one-half of the SE tax in withholdings and the corporation pays the remainder. Since they are shareholders, they bear this expense. The shareholders' dividends would avoid SE taxes, but the C corp typically distribute all its income as compensation to its shareholder/employees to avoid double taxation. Thus, as a practical matter, the C corp cannot avoid SE taxes as an S corp does by dividing compensation and distributions.

Franchise Taxes. The State of Oklahoma assesses franchise taxes against corporations, which are not assessed against partnerships or PLLCs. The rate is $1.25 for each $1,000 of capital. While the amount of the tax is likely insignificant for most professional corporations, the failure to pay the tax can result in a suspension of the corporation's charter. During the suspension, the directors and officers are personally liable for all corporate obligations incurred during the suspension. Reinstatement of the charter by paying the delinquent tax will not retroactively eliminate the personal liability.[36][37]

Complexity. Corporate governance assumes that directors will meet regularly (at least annually to elect officers), that the shareholders will meet annually (to elect directors), and that minutes will be kept reflecting the action taken at the meetings. The corporate statutes specify in detail the procedures for the call and conduct of such meetings.[49] These requirements do not apply to PLLCs or LLPs.

Hierarchical Structure. The distinct roles of shareholders, directors and officers can also create problems for professional corporations. The directors must authorize material corporate acts, which forces a subjective determination whether an act is material. Among the officers, levels of authority vary so that the president has greater authority than a vice president.[38] These distinctions also force determinations whether a

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[35] *See* Frank V. Battle, Jr., *The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages*, 57 Taxes 797, 809 (1979); Chapman, *The Future Personal Service Corporations*, 24 Ariz. L. Rev. 503, 526 (1982).

[36] *State Ins. Fund v. AAA Drafting and Engineering, Inc.*, 863 P.2d 1218 (Okla. 1993); *Bethlehem Steel Corp. v. Giese*, 1984 OK 28, 681 P.2d 769; and *K.J. McNitt Construction, Inc. v. Economopoulos*, 2001 OK CIV APP 45, 23 P.3d 983.

[37] At least 19 sections of the Oklahoma General Corporation Act deal in some manner with the conduct of, notice for, or voting at meetings.

[38] There can be only one president. There may be several vice presidents, although they must be ranked to establish succession.

certain person has the apparent authority to act for the corporation. Further, the distinctions in authority create a hierarchical structure in which the various officers are not equal participants in management. The lack of equality may be acceptable in larger professional corporations, in which the need for centralized management is wellrecognized. But in smaller professional corporations, the lack of equal participation may chafe.

The S Corp Advantages

Still a Corporation. The S corp is a state law corporation and brings with it the familiarity (and the complexities) of corporate operation.

Limited Liability. Like C corps, PLLCs and LLPs, the S corp protects its shareholders from personal liability for the acts and omissions of the corporation and its agents.

Self-Employment Taxes. A particular advantage of S corps is in the area of selfemployment taxes or FICA. SE tax is paid on all wages or compensation income. For 2017, the first $127,200 in wages and self-employment income is subject to the Social Security portion (12.4%) and the Medicare portion (2.9%) of the SE tax. The Medicare portion also applies to amounts over $68,400. Any profits higher than $127,200 remain subject to the 2.9% Medicare tax with a 0.9% increase for profits exceeding $200,000 for single people and $250,000 for married people filing jointly.

In a PLLC or partnership, each member or partner will pay SE tax on all his or her income. In a corporation, a shareholder/employee can divide the income between salary and dividend income. SE taxes are not payable on dividend income. In the C corp, such division would not be wise since the double taxation penalty is much greater than the savings from avoided SE taxes. But in the S corp, there is no double taxation penalty. The dividend income is taxed only at the shareholder level and escapes SE taxes.

This division should be used cautiously, especially if the shareholder is attempting to avoid SE taxes on amounts under the $127,200 cap. The Service may attempt to recharacterize the dividends as compensation, especially in a professional service business in which invested capital does not contribute materially to income.[39] In addition, one must also consider that reducing salaries also reduces the level of contributions that can be made to qualified retirement plans. Such contributions are deductible (thus reducing taxable income) and create further tax savings through the deferral of tax on investment income and gain. It is possible that a larger salary with the larger tax-deductible contribution to the retirement plan and tax-deferred growth within the plan may offset the tax savings that come from avoided SE taxes.

The use of distributions to reduce SEC taxes may also frustrate the shareholders' allocations of profits. Under the S corp rules, the distributions must be paid in proportion to

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[39] The IRS has increased its scrutiny of this area. *See David E. Watson, P.C. v. U.S.*, No. 111589 (8th Cir., Feb. 21, 2012); *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013180; *Sean McAlary Ltd. Inc. v. Commissioner*, T.C. Summ. 2013-62.

share ownership. Many firms want to distribute profits in other ways. The only alternative is to pay out the profits as compensation, which is subject to SE taxes.

The S Corp Disadvantages

S Corp Restrictions. In exchange for pass through tax treatment, S corps bear certain restrictions. The restrictions limit the number of shareholders to 100 and the authorized stock to a single class (although voting rights may differ within the class), which prevents the disproportionate allocation of income and costs. Most shareholders must be U.S. citizens, resident aliens, estates, or certain trusts.[40] For professionals, the inability to specially allocate income and costs can be a significant disadvantage.

Lack of Partnership Taxation. The specifics of the pass-through treatment differ between S corps and partnerships (and by extension, PLLCs and LLPs). The taxation of S corps blends corporate and partnership tax treatments. For example, the formation and dissolution of S corps may be taxable events, which are not recognized in the formation or dissolution of partnerships. This creates the possibility that a contribution or distribution of appreciated property by or to an S corp shareholder would be taxed, although a like contribution or distribution to an LLC member would not be taxed.[41]

A partnership permits certain basis adjustments that are not allowed in an S corp.[42] In a partnership, its liabilities will proportionately increase each partner's basis if no partner is personally liable for the liabilities.[43] If a partner's interest is transferred, the new partner may increase his or her basis by the amount of the appreciated assets in the partnership.[44] The S corp offers neither of these possible advantages.

The capital structure of a partnership is very flexible, which offers advantages. In a partnership, a professional may receive a profits interest in exchange for future services without the immediate recognition of income, while the similarly situated professional in the S corp would be taxed on the value of the shares received.[45] A partnership can also allocated income and loss disproportionately to the interests. For example, it may

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[40] I.R.C. §1361(b)(1).

[41] The distinction is particularly important when the entity repurchases a departing professional's interest. In both LLCs and S corps, professionals may provide contractual buyout rights. In an LLC, the payments made to purchase the member's interest may be treated as liquidating payments, which may be made with pre-tax dollars. *See* I.R.C. §736.

[42] *See gen.*, Sargent and Schwidetzky, *supra* note 6, at §3.3. These basis adjustment provisions would themselves offer a compelling advantage to LLC's over S corps. The advantage is, however, limited by the "at risk" and passive loss limitations under the Internal Revenue Code. I.R.C. §§465 and 469. The partnership tax rules also insure that built-in gain or loss attributable to contributed property will be allocated to the contributing partner. In an S corp, the gain or loss will be spread among all the shareholders.

[43] I.R.C. §752(a).

[44] *Id.* at §743(b).

[45] *Id.* at §83(a).

allocate the income from a particular case to a particular partner. An S corp must allocate income and loss strictly in proportion to the shares held. To do otherwise would create different classes of stock and violate the single class restriction.[46]

Unlike an S corp, the partnership need not make an affirmative election to obtain pass-through treatment.[47] In the partnership (and in a PLLC or LLP), such treatment is assured and may not be terminated by a majority in interest as in an S corp. In general, these tax differences favor partnerships, PLLCs and LLPs.

Franchise Taxes. S corps are subject to Oklahoma franchise taxes. While the amount is not significant, the failure to pay the tax can result in a suspension of the corporation's charter and personal liability for the directors and officers. See "*C Corp Disadvantages*" above.

Complexity and Hierarchical Structure. Because the S corp is identical to a C corp for state law purposes, it also has the disadvantages of operational complexity and a hierarchical management structure. The unique tax requirements for S corp status impose further complexities.

The Sole Proprietorship □Advantages and Disadvantages

The primary advantages of a sole proprietorship are the ease of formation and operation and the taxation of income at the owner level. Here the advantages cease. The most significant disadvantage is the absence of limited liability. First, the liability shield will protect against contractual liabilities. Second, while a liability shield will not protect against an owner's own acts or omissions, the shield will guard against liabilities created by other agents (assuming the owner was not negligent in hiring or supervising the agent) or independent contractors and against liabilities imposed on the entity by statute. These possibilities, in the author's mind, far outweigh the relatively nominal cost of forming and maintaining a limited liability entity.[48] Because the sole proprietor has selfemployment income, he or she is subject to SE tax on all earnings.

The Partnership □Advantages and Disadvantages

The advantages and disadvantages of the partnership are like those of the sole proprietorship, with one important exception. The partnership suffers from the additional disadvantage of making the individual partners responsible for the acts and omissions of every other partner, regardless of whether the partner was responsible for supervising or controlling the negligent partner. Under Oklahoma's RUPA, a partner is required to contribute amounts sufficient to satisfy partnership obligations and the partnership is

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[46] *Id.* at §1361; Treas. Reg. §1.1361-1(1)(2)(i).

[47] S corps must file with the Service an election to be taxed under Subchapter S of the Internal Revenue Code. *Id.* at §1362(a). Without the filing, the corporation will not qualify for S corp treatment.

[48] *See Ditty v. Checkrite, Ltd., Inc.*, 973 F Supp 1320, 1336 (D Utah 1997), in which the court refused to pierce the veil of a law firm LLC to impose liability on an attorney in the firm even though the attorney was the sole shareholder and director as well as the president of the firm and took an active role in it.

required to indemnify a partner for personal liabilities incurred in the partnership's business.[49] In the typical partnership, when a partner is found negligent, the partnership would indemnify him or her against losses and, if the partnership lacked sufficient assets to pay the claim, all partners would contribute amounts sufficient to satisfy the claim.

Conversion from an Existing Entity

Existing entities can convert from one form to another under Oklahoma law. For example, a corporation may convert to an LLC or vice versa.[50] But the conversion from one entity to another is not always a simple process. Important tax considerations can arise and these may influence a professional's decision to choose a certain entity.

If the professional is currently a sole proprietorship or partnership, he or she can usually become a PLLC without tax consequences.[51] The PLLC is, however, a new entity and the assets and liabilities must be transferred to the new entity (usually by an assignment and bill of sale if no real property is involved). Before converting, the professional must examine current agreements, including notes, security agreements and leases, to ensure that a default will not occur under these agreements upon a transfer or assignment. The need to obtain a consent to assignment is not unusual.

The process of changing from a partnership to an LLP is even easier, since no change of entity occurs. The partnership files a Statement of Qualification with the Secretary of State and must meet the insurance or security requirements. There are no tax consequences and no need to transfer or assign existing property or agreements since the entity remains intact.[64]

The conversion from a sole proprietorship or partnership (or PLLC or LLP) to a state law corporation will not trigger tax consequences if the 80% control test is met upon incorporation. The conversion will involve the transfer and assignment of assets and liabilities, which must be addressed. In lieu of conversion to a state law corporation, the partnership, PLLC or LLP could remain as such for state law purposes, but "check-thebox" to elect corporate taxation. This step gains corporate taxation (either C or S) and eliminates the costs of dealing with transfers and assignment.

The greater difficulties arise when converting from a corporation to a partnership or PLLC. Regardless of whether the conversion is handled as a conversion or merger for state law purposes, the conversion is a deemed sale or liquidation of the corporation and is taxable. In a C corp, the corporation is taxed on the difference between the fair market value of the assets less liabilities and its tax basis in the assets less liabilities. The

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[49] Okla.Stat. tit. 54, §1-401(c). The indemnification obligation requires the partnership to indemnify a partner for losses incurred in the ordinary course of the partnership's business, even if the losses arise from the partner's negligence.

[50] *See id.* at tit. 18, §§1090.4 and 1090.5 (corporations), tit. 18, §§2054.1 and 2054.2 (LLCs), and tit. 54, §1-902 (general partnerships).

[51] The conversion does not result in a deemed termination of the partnership for tax purposes. I.R.S. §708(b); Rev. Rul. 84-52, 1984-1 CB 157. A conversion will create tax liability if the

shareholders are taxed on the difference between the fair market value of distributions and the tax basis in their shares. In an S corp, the corporation recognizes gain to the extent that the value of the assets exceeds the basis in the assets. This gain is then passed through and taxed to the shareholders. Unless the asset value is lower than the basis (unlikely), the tax penalty for converting a corporation to a PLLC or LLP will usually rule out a conversion.

Conclusion

A review of the various advantages and disadvantages should rule out sole proprietorships, partnerships, C corps and LLPs. Sole proprietorships and partnerships are out for the lack of limited liability. Even though professionals remain liable for their own acts and omissions in any event, the use of a PLLC, LLP or corporation will limit the professional's exposure to contractual liabilities and torts or statutory breaches that he or she did not commit. Such protection is worth the filing costs and operating burdens.[65]

partnership's liabilities exceed its assets or the member is otherwise relieved of liability. I.R.S. §721(a).

[64] Okla.Stat. tit. 54, §1-1001. The partners will remain individually liable for pre-qualification obligations, such as loan agreements or leases signed prior to qualification.

[65] *See* Johnson, *supra* note 2, at 86-88.

The LLP suffers from being the only limited liability entity whose protection is contingent. It must post security, which is not required of other entities. While many professionals routinely carry adequate insurance (which qualifies as security), the risk is not worth the benefit when the PLLC offers almost identical advantages.

The C corp suffers from double taxation. While many professionals have grown accustom to avoiding corporate level tax through annual year-end bonuses, the practice has its price. Without incurring debt, the C corp will find it difficult to keep adequate capital reserves, and the maintenance of adequate capital is necessary to every successful business □professionals included.

The playing field is then down to PLLCs and S corps. PLLCs are the presumptive choice for small businesses generally. But professionals □as service providers □are unique. Professionals generate most of their income from invested labor, not invested capital. They often own no appreciable property and have little or no debt. In this situation, some of the substantial PLLC advantages are unusable. If income is sufficient to absorb all deductions, the basis step up opportunities are not needed. The lack of appreciable property means that the professional need not worry about unrealized gains being trapped in the corporation.

Still, the PLLC has other advantages. It can allocated income and loss disproportionately, which may be important to achieve the desired income splits between professionals. It can issue interests to new professionals without requiring them to pay the fair market value of the interests. It can deduct payments made to redeem departing professionals, which the S corp cannot do. The PLLC also avoids the hierarchical management structure of the S corp. In exchange, the PLLC members may pay more SE tax than would an S corp shareholder/employee.

If the professional entity always has ample income, does not add members, does not lose members, does not own appreciable property, and distributes profits based on share ownership, a PLLC with an S corp election may be the better choice. The PLLC with an S corp election avoids the complexity of corporate operations, the hierarchical management structure, and franchise taxes while retaining the S corp treatment for SE tax. For professionals wanting greater flexibility, the PLLC is the superior choice.

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