

# CHOOSING THE RIGHT ENTITY FOR NEW HAMPSHIRE LAW FIRMS: BASIC TAX AND NONTAX GUIDELINES

By John M. Cunningham<sup>1</sup>

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## I. INTRODUCTION AND SUMMARY

Under New Hampshire business organization law statutory rules and under the administrative rules of the New Hampshire Supreme Court, lawyers beginning or conducting solo practices can structure these practices either as sole proprietorships, single-shareholder professional limited liability companies (“PLLCs”) or single-shareholder professional corporations (“PCs”). Under these rules, two or more New Hampshire lawyers beginning or conducting a group practice can structure their practices either as traditional general partnerships, limited liability partnerships (“LLPs”), multi-shareholder PCs or multi-member PLLCs.<sup>2</sup>

Which of these various state-law business entities is likely to be best for these lawyers? Does the choice really matter?

To answer these questions, one must conduct two types of analyses, often referred to as, respectively, nontax choice of entity and tax choice of entity.<sup>3</sup> Each of these types of analysis can, in particular cases, be very complex. In this article I will address only the most basic considerations in making tax and nontax choice-of-entity analyses. However, I can assure readers that these considerations will decide the vast majority of real-world entity choices by New Hampshire lawyers.

The conclusions set forth in this article can be briefly summarized as follows:

- Lawyers in solo practice who have no lawyers or other employees working for them should at least seriously consider practicing as sole proprietorships.

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<sup>1</sup> Mr. Cunningham is of counsel to the Concord, New Hampshire law firm of Ransmeier & Spellman, P.C. He is the author of *DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS* (Aspen Law and Business), the leading U.S. LLC formbook and practice manual.

I am grateful to Richard A. Samuels, Esq., of McLane, Graf, Raulerson & Middleton, P.C., for his astute comments on an earlier version of this article. However, responsibility for any errors in the article is mine alone.

<sup>2</sup> See generally, Rule 41, Administrative Rules of the New Hampshire Supreme Court; RSA 294-B (Professional Corporations); RSA 304-A:15,II; RSA 304-A:44-55 (Limited Liability Partnerships); RSA 304-D (Professional Limited Liability Companies). By “traditional” general partnerships, I mean general partnerships that have been formed under RSA 304-A but that have not registered with the New Hampshire as LLPS. LLPs are general partnerships that have registered with the New Hampshire Secretary of State under RSA 304-A:44 and have thus obtained a partial statutory limited liability shield for their partners. As discussed in greater detail below, this shield protects the partners only from vicarious liability for, in general, negligence and willful misconduct.

<sup>3</sup> Detailed discussions of how to make tax choices of entity and nontax choices of entity may be found in, respectively, Chapters 4 and 10 of *DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS*, cited in footnote 1.

If they decide not to practice as sole proprietorships, they should practice as single-member PLLCs.

- Lawyers in solo practice who do have employees should normally practice as single-member PLLCs.
- Whether or not they have employees, lawyers in group legal practices should normally practice as multi-member PLLCs.

## II. LAWYER SOLO PRACTICES

Nontax Considerations. Linda Lawyer has just graduated from law school. She decides not to join an existing law firm, but rather, to practice on her own. From a nontax viewpoint, which is the best entity for her practice - a sole proprietorship, a single-member PLLC or a single-shareholder PC?

The conventional wisdom holds that lawyers should never practice in sole proprietorships, since, as every first-year law student knows, sole proprietorships do not provide their owners with limited liability.

It is true that if, either when she begins her practice or in the reasonably foreseeable future, Linda will have even a single employee, she will need a liability shield and thus should not conduct her practice as a sole proprietorship. This is because, as a sole proprietor, she will have strict personal liability for any misdeed of her employees under the principle of *respondeat superior*. This will be the case even if she has not participated in the misdeed in question and even if this misdeed was contrary to her express instructions.

However, as long as Linda is practicing *without* employees, a liability shield cannot protect her from claims arising what is by far her single greatest risk – namely, the risk of incurring a judgment for malpractice . This is because no statutory liability shield can protect a person from the consequences of his or her personal misconduct.

Thus, as long as Linda has no employees, conducting her practice as a PLLC is unlikely to bring her any practical benefits, and she should at least seriously consider practicing as a state-law sole proprietor.<sup>4</sup>

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<sup>4</sup> However, in the somewhat improbable event that she is able to obtain an office lease or other contractual arrangement for her practice in the name of an entity rather than in her own name, she should conduct her practice as a PLLC. (The reasons why she should not use a PC are discussed later in this article.) Furthermore, even if Linda decides that the legal benefits that she may derive from a PLLC are at best speculative, single-member PLLCs are cheap and easy to form and maintain and could conceivably provide her someday with a liability shield in a way she can't presently imagine. She may also decide that practicing as a PLLC may make her practice appear more substantial and thus may provide her with marketing benefits.

However, against these speculative benefits of conducting as a single-member PLLC a law solo practice with no employees, she should weigh the costs and inconveniences of taking the various measures

If Linda *will* have one or more employees and thus *will* need a liability shield, which will be better for her from a nontax viewpoint – a single-member PLLC or a single-shareholder PC?

Both of these types of entities will provide Linda with limited liability. However, PCs are merely a particular type of business corporation, and business corporations have a complex tripartite management structure (shareholders, directors, officers) which makes no sense for Linda.<sup>5</sup> By contrast, the management structure of a single-member LLC is essentially the same as that of a state-law sole proprietorship. Thus, the PLLC management structure will be a far more intuitive and user-friendly management structure for Linda than the PC structure.

In addition, in order to fully protect their limited liability “veil,” the shareholders of PCs must comply with a wide array of corporate statutory formalities.<sup>6</sup> The New Hampshire PLLC statute imposes no such formalities. For this reason, too, if Linda has employees, she should practice as a PLLC rather than as a PC.<sup>7</sup>

Tax Considerations. Which available type of entity - a sole proprietorship, a single-member PLLC or a single-shareholder PC – will be best for Linda from a tax viewpoint? The short answer is that all of them will be equally bad. No matter which of these entities she uses to conduct her practice, and regardless of whether she has employees, Linda will have to pay essentially the same federal income taxes, the same Social Security Taxes, and the same New Hampshire Business Profits Tax (“BPT”) and Business Enterprise Tax (“BET”).<sup>8</sup>

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necessary to prevent PLLC veil piercing. These anti-veil-piercing measures include, among others, (i) maintaining PLLC books and records that are entirely separate from her personal books and records; (ii) ensuring on a continuing basis that her PLLC has adequate capitalization; and (iii) always making it clear to third parties that, counterintuitively, it is her PLLC, and not she herself as an individual, that is conducting her practice and rendering legal services.

<sup>5</sup> Briefly, the corporate management structure was designed for entities that have one or more passive investors who want to appoint third parties (directors) to supervise the entity’s day-to-day managers (the officers). Needless to say, this classic corporate fact pattern has no application whatsoever to Linda’s solo practice.

<sup>6</sup> For example, in connection with the formation of New Hampshire business corporations, their organizers normally must issue stock certificates, adopt bylaws, and adopt organizational resolutions, and, in connection with the operation of these corporations, the shareholders must hold annual shareholder meetings or their equivalents, the directors must hold “regular” director meetings or their equivalent, and corporate management must create and maintain documentary evidence that they have done so in minutes or written consents. *See generally*, RSA 293-A:2:05, 2:06, 6:25, 6:26, 7:01-7:07, and 7:20.

<sup>7</sup> Linda may also want to use a single-member PLLC to conduct her practice in order to obtain statutory business asset protection under Section 47 of the New Hampshire LLC Act. However, as discussed further in footnote 11, it may be questioned whether this benefit is available to New Hampshire single-member LLCs or PLLCs.

<sup>8</sup> A detailed discussion of Linda’s potential federal income tax, Social Security Tax and New Hampshire state tax liabilities is beyond the scope of this article. However, briefly, her entire professional income will be subject to federal income tax and Self-Employment Tax if she conducts her practice as an entity classified for federal tax purposes a sole proprietorship; and any reduction of these taxes that she may realize by conducting her practice as a PC taxable under Internal Revenue Code Subchapters C or S will be largely or entirely lost by reason of the impact of one or more of (i) Subchapter C itself, (ii) the BPT, (iii) the BET and (iv) the I&D Tax.

In short, in Linda’s case (and in the case of all New Hampshire solo practitioners), choice of entity boils down to nontax choice of entity; and, as indicated, nontax choice of entity mandates for Linda the use of a sole proprietorship or a PLLC.

### III. LAWYER GROUP PRACTICES

Nontax Choice Of Entity. John Doe and Mary Roe have just graduated from law school. They decide to join forces in a new two-member group legal practice. From a nontax viewpoint, which of the four types of New Hampshire state-law entities that are available to them – namely, a traditional general partnership, an LLP, a two-shareholder PC or a two-member PLLC – will be best for them? The answer is a PLLC. Here’s why:

- Traditional General Partnership. Mary and John should not conduct their practice as a traditional general partnership because partnership business organization law will impose on each of them unlimited vicarious liability for claims against the other and against the partnership.<sup>9</sup> Thus, if John is held liable for malpractice, Mary could lose everything she owns or may come to own (potentially including even a significant portion of her future income); and if Mary is held liable for malpractice, John could lose everything he owns or may come to own.
- LLP. Mary and John should not conduct their practice as a LLP because, under New Hampshire business organization law, LLPs will shield each of them only against five specified types of claims against the other – namely, “[i] omissions, [ii] negligence, [iii] wrongful acts, [iv] misconduct or [v] malpractice.” (Brackets added.) LLPs will not shield them from any other types of claims, such as those based on bankruptcy or sexual harassment statutes or on contract claims other than those based on negligence.<sup>10</sup> This is bad news for most lawyers, since, among other considerations, malpractice claims sounding in negligence can often be recast as contract claims alleging failure to comply with implied contractual duties of competence; and lawyers are just as vulnerable as nonlawyers to statutory claims.
- PC. Mary and John should not conduct their practice as a PC for two main reasons. First, the complex and cumbersome tripartite PC corporate management structure will make no more sense for them as a group that it makes for Linda as a sole practitioner. Mary and John will want an informal and user-friendly management structure that fits the reality of their professional relationship.

Second, as discussed above in the case of Linda Lawyer, if Mary and John want to maximize their PC liability shield, they will have to comply with a variety of corporate statutory formalities. PLLCs don’t impose these formalities.

- PLLC. For three main reasons, Mary and John should conduct their practice as a PLLC. First, as indicated, PLLCs provide a liability shield without any need to

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<sup>9</sup> RSA 304-A:15,I.

<sup>10</sup> RSA 304-A:15,II.

comply with statutory formalities. Second, the type of PLLC generally described by business lawyers as a “member-managed” PLLC provides a highly informal and flexible general partnership-like management structure that, in all probability, will be by far the best management structure for Mary and John.

Third, a PLLC will provide Mary and John with what LLC lawyers call “statutory business asset protection.” This means that if John or Mary ever incur a liability in their personal capacity, the fact that they conduct their practice as a PLLC will prevent their creditors from obtaining their PLLC management rights and thus being able to force the sale of their PLLC assets in satisfaction of their debts.<sup>11</sup> Traditional general partnerships, LLPs and PCs don’t provide statutory business asset protection.<sup>12</sup>

Tax Choice of Entity. Which of the above types of state-law entities will be best for Mary and John from a tax viewpoint? This question involves a number of subsidiary questions:

- Federal Income Taxes. First, which federal tax regimen will be best for Mary and John from a *federal income tax* viewpoint? There are three possible federal income tax regimens available to Mary and John: Internal Revenue Code Subchapter C, Subchapter K (partnership taxation) and Subchapter S. For most group practices of law, including that of Mary and John, the best of these regimens from a federal income tax viewpoint will be Subchapter K. Among other advantages, Subchapter K will provide Mary and John with great flexibility in allocating income and expenses between them on an equitable basis; it will permit tax-free contributions of appreciated assets by members joining the PLLC after its formation; if Mary and John dissolve their practice, it will allow them to distribute PLLC assets between them without tax; and it may enable them to arrange for better buy-out provisions than are available to them under Subchapters C or S.<sup>13</sup>
- Social Security Taxes. Second, which federal income tax regimen will be best for Mary and John from a *Social Security Tax* viewpoint? The short answer is that all three available regimens will be equally bad. Thus, the choice of federal income tax regimen won’t matter.<sup>14</sup>

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<sup>11</sup> The provision of the New Hampshire LLC Act that provides statutory business asset protection is RSA 304-C:47. This section provides, in effect, that the only remedy for creditors of LLC member-debtors is a “charging order.” Charging orders are, in effect, court-ordered liens under which distributions to these members must instead be made to creditors holding these liens.

<sup>12</sup> In light of the recent decision of a Colorado federal bankruptcy court in *In re: Ashley Albright, Debtor*, Case No. 01-11367 - ABC, Chapter No. 7 (2003 Bankr. D. Co. LEXIS 291), it is questionable whether single-member LLCs can provide statutory business asset protection. This is because, as emphasized by the *Albright* court, the legislative purpose of the LLC charging order provisions that provide this protection is to protect innocent non-debtor members from losing the going-concern value of their LLC. By definition, single-member LLCs have no such members.

<sup>13</sup> See generally Internal Revenue Code Sections 701, 704(a), 721(a), 731(a), 734(a), 736, 743(a) and 754.

<sup>14</sup> See generally Internal Revenue Service Prop. Reg. §1.1402(a)-2, which provides, in effect, that all professionals, including lawyers, who conduct their practices as multi-owner unincorporated business entities classified for federal income tax purposes as partnerships must pay full Self-Employment Taxes on

- New Hampshire Taxes. Third, which federal income tax regimen will be best for them from a *New Hampshire state tax* viewpoint – *i.e.*, from the viewpoint of the BPT, the BET and the I&D Tax? In general, the answer is the same as with regard to Social Security Taxes: all three regimens will be equally bad.<sup>15</sup>
- Federal Tax Classification. If, then, on the basis of the above considerations, the best federal income tax regimen for Mary and John on an overall basis is partnership taxation under Internal Revenue Code Subchapter K, which types of state-law entities can qualify for Subchapter K treatment under applicable federal tax classification rules? The relevant rules are those contained in U.S. Treasury Department regulations known as the “Check-the-Box Regulations.”<sup>16</sup> Under these rules, Mary and John can obtain partnership taxation if they conduct their practice as a general partnership, an LLP, or a PLLC, but not if they conduct it as a PC.

The Bottom Line. The bottom line is this: When we weigh all of the relevant nontax and tax choice-of-entity considerations, it becomes clear that Mary and John should conduct their new group legal practice as a PLLC.<sup>17</sup>

#### IV. CONVERSIONS OF NON-PLLC LAW FIRMS TO PLLCs

What if Linda is already practicing as a sole practitioner in a sole proprietorship and, after reading this article, she wants to convert to a PLLC? The process is a quick and easy one, and it is tax-free.

What if she is practicing as a PC and wants the simpler management structure of a PLLC? She can obtain this structure by taking advantage of RSA 293-A:7.32. This section of the New Hampshire Business Corporation Act provides, in effect, a statutory means of converting a corporate management structure to that of a sole proprietorship or a partnership.

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their professional income. As to the impact of Subchapter C and Subchapter S on the Social Security Tax liability of professionals, see footnote 7.

<sup>15</sup> However, to the extent that, in order to reduce their BPT, Mary and John want to pay out to themselves all of their entity net income by year-end, this will often be easier if their entity is a PLLC classified for BPT purposes as a partnership than if it is a PC classified as a C corporation.

<sup>16</sup> Treas. Regs. section 301.7701-3.

<sup>17</sup> However, Mary and John should be aware that once they have resolved their tax and nontax choice-of-entity issues, they must also sooner or later also address in a PLLC agreement numerous other issues that have nothing to do either with tax, with liability shields, with business asset protection, or with management structure. These other issues, each of which may eventually become critical to the survival and success of their practice, include, among many others, issues concerning their mutual duties of care and loyalty, the dissociation events upon whose occurrence they will want PLLC memberships to terminate, related issues concerning member suspensions and expulsions for misconduct, and issues relating to buy-sells and dispute resolution. When Mary and John are first starting their practice and their time and money are scarce, they may well decide to defer their consideration and resolution of these issues in a PLLC agreement. However, once their practice takes root, they will neglect them at their peril.

What if she is practicing as a PC and wants to avoid PC corporate formalities so that she can avoid the expenses and inconveniences that they impose and can thus lessen her risk of veil piercing? She can easily make a statutory conversion of her PC to a PLLC under RSA 293-A:11.09 and RSA 304-C:17-a; and under Internal Revenue Code Section 368(a)(1)(F), her conversion will be tax-free.

Finally, what if Mary and John are practicing jointly as a traditional general partnership, LLP or PC and want the legal advantages of a PLLC? They can change their PC corporate management structure to that of a general partnership by taking advantage of RSA 7:32, or, in order to obtain the full range of PLLC benefits (simple management structure, better liability shield, statutory business asset protection), they can convert their non-LLC entity to a PLLC under the statutory provisions cited in the previous paragraph.<sup>18</sup>

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<sup>18</sup> The conversion of traditional general partnerships and LLPs to PLLCs is tax-free under, among other federal tax authorities, Rev. Rul. 95-37 and PLRs 200022016, 199607006, and 1996333021.