Is Your Practice Structured to Avoid Taxes?

Here's a look at tax entities.

BY COLIN MCKAY

Editor's Note: This article was a recent winner of the annual American Podiatric Medical Writers Association (APMWA) Student Writing Competition.

Life as we know it in the medical arena is about to change. Business cannot be run the same way it once was, but you can still maintain the traditional patient-doctor relationship, and be able to operate a prosperous practice.

The medical arena is going into a new era of healthcare. Besides the changes in healthcare laws, approximately 44% of podiatrists currently in practice will be reaching retiring age within the next ten years, according to *Podiatry Management's* 30th Annual Survey.[1] Billable fees are also decreasing. The same survey noted a 7% drop in the average fee for 15 common procedures. According to the U.S. Census Bureau, in the next 15 years, an estimated 71 million Americans will be age 65 or older, which is a 200% increase from the year 2000. This means that we will have a proportional increase in the number of patients coming through our practices. In the next 10 to 20 years, we will likely see our profession having a need to cut costs and work together to maximize efficiency to help an increased pool of patients with fewer podiatrists.

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According to *PM's* survey for 2012,[1] the most common type of practice was a self-employed or solo practitioner practice. Some were in a single member corporation, partnership, or a multimember corporation with other DPM's. For years, podiatrists like my father (who has worked in his own small practice for years)have done well; however, this state of affairs changed two years later in *PM*'s 32nd Annual Survey, when for the first time, partnership/group participation surpassed that of solo DPM's, and net income rose significantly. In 2012, it was noted that solo practitioners had an average net income of $117,750, whereas group practice members had an increased net income of $125,000. Two years later solo doctors' take-home pay was nearly 25% less than the share of net income earned by partnership/group colleagues. It certainly appears that working in groups is going to be a more common strategy to cope with the changes we have ahead.

This paper is designed to communicate some of the simplest and most powerful information available for business owners about savings

Continued on page 168

Practice Structure (from page 167)

and asset protection. It is not meant to replace consulting with your tax accountant or attorney, but will hopefully help you ask the right questions.

As a podiatrist, one of the largest expenses you have is taxes. There are two types of ways you can cut these expenses: tax avoidance, and tax evasion. Tax avoidance is the legal route to taking advantage of the tax law to cut your taxes, and merely involves structuring your business and your finances in a way to avoid taxes. Judge Learned Hand said in 1947, "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible."

There are many examples of powerful and simple tax avoidance strategies, but before we entertain that discussion, we need to have a basic understanding of the different entity types available. The five basic tax entities include: Sole Proprietorship, Limited Liability Company (LLC), Partnership, Corporation (C chapter), and 'S' Corporation (S chapter).

Tax entities are legal organizations for your business that are subject to different taxing regulations, and come with benefits such as asset protection, and tax savings.

Sole Proprietorship

Sole proprietorship is the simplest form of a business. No paperwork is necessary, just open your doors and start your business. Since it is simple, it also means cheap legal and accounting fees. The downside is that you are personally liable for everything. In the event that you are sued, you are sued individually. This means that if a bystander walks on your property, trips and injures himself and decides to sue, he will sue you directly. He can go after the assets included in the business, and also your personal assets, such as your house and personal car.

When you are taxed, your taxes show up on what is called a Schedule C on your personal tax return. These taxes are not only subject to your personal income tax rate, but also to a self-employment tax, which in 2014 is 15.3% (12.4% for social security for the first $106,800 of income, and 2.9% for Medicare) and are paid quarterly. There is also a 0.9% Medicare tax for people above the income threshold. The highest federal tax rate is 39.6%, and depending on the state, you could be taxed an additional 10-15 % tax on top of that. The higher amount of taxes you pay is the price for simplicity. However, this still may be a perfectly viable route to go. All you may need if you go this route is some good insurance.

Limited Liability Company (LLC)

For an LLC, you can be a single member, multiple members, or a manager LLC. Problems can occur when you form an LLC but have not activated it. Many people operate thinking they are covered by the protections that an LLC provides when, in fact, they are not.

One of the benefits of the LLC is added protection. The principle reason tax entities were established was to provide legal protection where legal protection is due. It also protects you personally from the acts of your partners, employees, or business in general. You are only liable for the assets held within the company. If an employee runs someone over in a company car, you are not sued individually, but the employee and LLC will be sued. In order to maintain this legal protection, you must operate within what is called the corporate veil (only applicable to C or S corporations).

An LLC is created when you file the required documents with the designated officer of the state.

The corporate veil is simply the laws and regulations members must abide by to legally stay in a corporation. One of the things you are required to do is to separate yourself from the entity, e.g., don't pay your home mortgage through the LLC. If you operate within the corporate veil, your personal assets will be protected. If you 'pierce' the corporate veil, you could be disallowed the LLC's protection, allowing the plaintiff suing you ability to sue for your personal assets. If you are within the corporate veil and you put $100,000 into the LLC/Corp, and incur

Continued on page 169

Practice Structure *(from page 168)*

$200,000 of debt, you are only potentially liable for the $100,000 dollars. The creditors can't pierce the corporate veil. For more information about the corporate veil, talk to your tax accountant or attorney.

An LLC is created when you file the required documents with the designated officer of the state. In California, this file goes to the California Secretary of State. It is required to have one member and one manager. There is great flexibility concerning how it is managed and directed; they can be individuals or other entities. The fact that individuals or entities can be members of an LLC gives great advantage in many scenarios. LLC's don't have as many paperwork requirements as a C or S corporation, but are more complicated and more expensive to maintain than your sole proprietorship. For example, the State of California requires an 800-dollar yearly filing fee. If you earn over $250,000 in gross receipts, you will pay an additional $900, and it goes up to 11,790 for 5 million dollars of gross receipts.

The biggest pro of a corporation is that it has the most protection available, meaning that it is particularly good if you have employees.

In a single member LLC, you don't have to file a federal tax return for the LLC, even though some states require separate returns, California being one of them as it only reports the activity on the personal tax return. It is easy to set up and relatively inexpensive, requiring usually no more than a couple hundred dollars.

A con is that LLCs also are usually subject to state taxes. For example, in California, there is a $20 reporting fee and a statement of information that is required 90 days after formation and then every two years after that. An annual $800 tax is due 75 days after formation, and a minimum $800 dollar income tax is due every year regardless if you made a profit or not. In Oregon, $400 dollars minimum are required in tax, which is more common for many states. As an LLC, you can elect to be taxed as a Partnership or a C-Corporation. In some states, certain professionals, including doctors, may not be allowed to be an LLC.

Partnership

You can be in a partnership and not know it. If you decide to sell lemonade on the street and shake hands with your neighbor to sell lemonade together, that is considered a partnership; creating a partnership doesn't require legal documents. Generally, in a partnership, you can be sued for the faults of your partner. So, when doing business with other people, make sure you do appropriate paper-work to get the desired asset protection, or simply don't do business in the first place, or else you can find yourself in an undesirable situation.

However, there are different types of partnerships, like a limited partnership. This is a partnership where there is at least one general partner, and the other partners have limited liabilities. These other partnerships usually require at least one partner to be the general partner, who is liable for the entire company. The other limited partners are protected, but they cannot participate in the business, so this would only be applicable if you had a side business that is being run by someone else.

For the most part, partnerships have the great benefit of having a great amount of flexibility. This is due to U.S. law allowing the partners to agree on how the income of the entity will be allocated among them, whereas S corporations are strictly decided according to the amount invested by the partner. However, the allocation is required to reflect the economic reality of their business arrangement, and there are rules that test this. This is considered a flow-through entity, an entity that itself does not pay taxes, but that passes the tax burden onto the owners, who pay it as personal income tax.

Corporation (C Chapter)

The biggest pro of a corporation is that it has the

Continued on page 172

Practice Structure (from page 169)

most protection available, meaning that it is particularly good if you have employees. Once again, corporations were created for the purpose of protecting owners from personal liabilities against the company and claims in contract or tort. It also has the greatest capabilities to raise capital. That may be needed if you are thinking about starting up a big clinic.

Some of the cons include getting money out without being taxed at the high corporate rates or by not piercing the corporate veil, a potentially difficult task. One of the ways you can overcome this is by renting out a home office. If you do considerable work at home, the corporation can pay a rental fee to rent your home office. Be mindful of the rules about home offices, though, and always be sure to consult with a tax accountant.

Certain benefits are available, such as being able to employ your spouse and children. Employing your children also comes with a potential tax advantage by giving them a reasonable pay, which will be taxed at their low tax rates, and will give the corporation an added deduction against their taxable income.

And of course, there is a potential financial benefit to this option. If you have a separate business that doesn't make more than $50,000 a year, your income in that business remains in the lowest tax bracket of 15%, whereas personal tax bracket for that same amount can get as high as 25% (if you're a single tax payer; married and filing jointly is still roughly that same amount). So, being a corporation for smaller amounts of money can be better than sole proprietorship or partnerships.

Furthermore, assuming you are in the 39.6% tax bracket (the top tax bracket) and you have an orthotics lab that brings in a significant income, but still not too much more than $75,000 a year, you can put that into a corporation, taking that extra $75,000 from paying 35% to paying 15%. That is a potential savings of $15,000. However, you still have to pay tax on dividends, so you may want to find another way to get your money out of the corporation. Also, it will require more paperwork and it is more expensive to maintain, so it is important to talk to your tax coach to make sure it is the right move for you.

Also, as a shareholder in your corporation, you can pay yourself a dividend. Dividends are taxed at a lower tax rate. If you are in the highest tax rate, you will usually pay around a 20% rate for dividends, a difference of upwards of 20%. Unfortunately, dividends are not tax deductible for the corporation, but are a good way to get your money out of the corporation in a way by which you pay less personal taxes

Depending on your circumstances, you can employ two or more of these entities to your advantage.

'S' Corporation (S Chapter)

The 'S' just stands for the subchapter S of Chapter 1 of the internal Revenue Code, where S corporation regulations are found. They are like C corporations under the laws of the state in which the entity is organized. But for Federal income tax purposes, taxation of S corporations resembles that of partnerships. Income is taxed at the shareholder level, not at the corporate level. S corporations have stricter guidelines than LLCs. First off, you must qualify to become an S-corporation by:

- Having U.S. citizenship or residency
- Not having more than 100 shareholders
- Having only one class of stock (you can't have preferred and common stock)
- Distributing profits and losses to the shareholder in proportion to the shareholder's interest
- Limiting ownership so that shareholders cannot be other corporations
- Not having more than 25% of your gross receipts from passive income (i.e., interest and dividend income)

If you're a practicing podiatrist chances are that none of these requirements are limitations to you. However, it does cost more to form an S-corporation, and it's more complex, meaning a bigger bill from your accountant/lawyer.

For Federal income tax purposes, taxation of S corporations resembles that of partnerships.

S-corporations are flow-through entities; taxes are paid through the partners. The financial advantage comes when the S-corporation pays out a 'reasonable' salary to the owners, and the rest can be paid to the owners in the form of a distribution/dividend. Or you can keep it in the S-corporation to be reinvested or to just be taken out when needed. While the salary is subject to FICA taxes, the excess income is distributed as dividends to the owners, which are taxed at a lower rate.

There needs to be some discussion on what is deemed to be a reasonable salary. You might be tempted to pay yourself $20,000 a year, and have a big savings in self-employment taxes, but that would probably trigger IRS tax fraud alerts, and you could get audited, and be made to pay a significant amount in taxes, penalties, and interest. They could argue in court that, being a podiatrist, you should have to receive a

Continued on page 174

Practice Structure (from page 172)

salary of about $124,000, the latest average salary of a podiatrist in America. If you have a particularly prosperous practice, they could argue that even more should be paid. A tax accountant can calculate what amount would safely be deemed reasonable for you.

A comprehensive plan should be made with assistance of a tax accountant/lawyer.

Combination of Entities

Depending on your circumstances, you can employ two or more of these entities to your advantage. If you are in practice with another podiatrist who is co-owner with you, you can set up a business utilizing multiple tax entities. You can set up a payment company that is a partnership, and each individual podiatrist can be his/her own S-corporation who is a partner of that partnership via the S-corporation. The partnership will receive the revenue, and be distributed to the S-corporations that are partners. This allows you to take advantage of the flexibility of the partnership, but also gets the good tax benefits and asset protection of the S-corporation. There are endless scenarios that can also be imagined. For more details talk to your tax coach/attorney.

With a tax code over two million words long, there are many other ways to save on taxes legally, while adding protection to your assets. Trusts and estates can be used for additional asset protection, depreciation, home office, employment of family, and can be used to save on taxes. A comprehensive plan should be made with assistance of a tax accountant/lawyer. **PM**

References

[1] Podiatry Management, February 2013 issue, PM's 30th Annual Survey, pg 101-164.

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