

LLP or LLC for Two-Person Law Firm?

An August 2010 discussion on SoloSez, the email listserv for general practice, solo and small firm lawyers

I'm considering opening up a firm with one other attorney, but we're still perplexed as to whether we should opt for an LLC, LLP, or LLLP, for that matter (we're in Colorado). I've done some research on my own but am far from confident as to what would be the best choice. We have limited funds so are trying not to have to formally consult with a business attorney. Has anybody recently had to make a decision on this issue, and if so, would you care to share specifically why you chose one entity over the other? Thanks, your thoughts are greatly appreciated!

Did you search the archives before posting this one?

However, I do think the LLC vs. LLP thread has been done to death.

<http://mail.abanet.org/scripts/wa.exe?A0=SOLOSEZ>

My understanding is there is little difference between the two forms. LLC has pass through taxation but requires a separate return for the LLC, LLP doesn't?

Jake C. Eisenstein, Colorado

Not to be negative, but the key is that you consider what will happen when you break up the firm ...

John Scanlan, Colorado

LLCs and LLPs are, by default, partnerships for tax purposes that enjoy pass-through taxation and require the filing of the partnership Form 1065 information return. Now, you can change that to corporate form (double taxation) by electing on Form 8832 entity classification election to be treated as a corporation filing corporate Form 1120 tax return. Such a corporation (for tax purposes) can also, if it meets the requirements, make an S election on Form 2553 to turn the entity into an S corporation which gets much of but not full pass-through taxation.

The one time an LLC gets away without having to make a separate income tax return is if you have a *single-member* LLC which for tax purposes is treated as a "tax-nothing" and

all of its income and expenses get reported as if it were a sole proprietorship on the member's Form 1040 Schedule C.

A LLLP is a Limited Liability *Limited Partnership* which is a limited partnership who's general partner is also afforded limited liability without having to use the corporate form for that general partner. Contrast with a limited partnership which generally is formed with a corporate general partner and various limited partners.

Although this covers the basic federal issues, there are also state level issues to consider such as California's gross receipts tax on LLCs which it doesn't have on other business entities.

Greg Zbylut and I will be the first ones to tell you that if you aren't sure what you're doing from an accounting perspective that you should seriously consider getting a CPA on board.

--Vince

Vincent Kan, Illinois

We just opened up a 2-attorney firm in April and went through the same consideration. In Texas, the legal rights, responsibilities, and protections are similar for the different entities. We made the final decision based on advice from our CPA, who had a strong recommendation based on the tax ramifications. If you have not yet discussed the decision with a CPA, you should (unless you - unlike me! - understand taxes on your own). Our CPA gave us the advice free, as a golden nugget to lure our future paid business.

Amber L. Slayton

This is why I hate it when CPAs advise on COE questions...there's more to this than which is tax favored.

There's two facets to this decision. John Scanlon hits on one - which one is easier to unwind (or to add parties to), and which one has better tax advantages.

I'd address the latter question by talking to your potential partner - you may find that they do not share your objectives. For example, I had two partners in my office earlier this year who had very different perspectives on losses. One wanted them, the other did not. Huh? He didn't want tax losses? Yep. Seems he already maxed out on tax losses, and had so many carryforwards that he thought he'd never use them. In fact, he wanted profits so he COULD use them. So it was an important discussion to have.

An LLC is ALWAYS a 'tax nothing' (to use Vincent's term). You must pick how you want to be taxed - as a Corporation, an S-Corporation, or a partnership (of course, SMLLCs can also pick sole proprietor). An LLP is a partnership - period. Both have advantages and disadvantages, including flow-through, loss deductability and what 'fill ins' may kick in for a poorly prepared agreement. Most states tax both partnerships and LLCs, but some states (many? I'm not up on all 50) charge annual fees for LLCs. A partnership is much easier to form (well, not an LLP, though) and can be easier to dissolve.

One important part of any partnership, though, is profit and loss allocation. Partnerships can vary their allocations - one partner gets 50% of the gains and 100% of the losses, for example - but LLCs which elect S or C status MUST allocate income by the respective shareholder's share. You put in 10% of the money? You get 10% of the gains and 10% of the losses. Now, there are people who will say "Yeah, but what about sweat equity?" (in other words, 10% of the money, but some other % of effort (say, 80% of the work)) To that I say, "prove it." If you have to, how do you prove you did 80% of the work and the difference is to compensate you? Better yet, how do you prove the value of your time? That's the tough part.

And a shout out to Vincent for spelling my name right.

Grteg Zbylut, California

Another (although very small) consideration is who you are dealing with and the ease of renewal. In Georgia, the LLP "registration" goes through the Clerk of the Superior Court. You cannot register online, nor can you make amendments online. On the other hand, LLCs are done through the Secretary of State and renewal is very easy. And they remind you every year, usually even several times. For the lawyers and general business persons that don't do this on a regular basis, ease of administration is generally a factor that I add to the equation on COE questions.

I hate to say it, but I think all the tax and business lawyers have shown that you probably do want to consult with a CPA AND a business lawyer in Colorado. There are a lot of issues that are going to vary based on your and the other lawyer's individual situations. Profits and losses, employment taxes, capital contributions, and a whole slew of other considerations. I tend to like LLCs based on their flexibility, but they do require extensive operating agreements to account for all the flexibility. And to do that right, it requires a business law attorney familiar with the tax issues. Even a partnership agreement for a LLP or LLLP should be done by a business law attorney.

Properly setting up a business is like a pre-nup for those getting married. Yes, it feels like you are preparing for the worst - breaking up. But as high as the family law divorce rate is, I think the "divorce" rate for law partnerships reaches much higher. And as lawyers, you will fight over the smallest issues. Spell out up front how you are going to break up and save the headaches later on.

Kimberly DeCarrera, Georgia

Actually, the "tax nothing" I was referring to is what the IRS calls a "disregarded entity." Partnerships or entities that can make (but may not be required to make) an 8832 election to be treated as partnerships have flow-through tax treatment where the partnership as an entity does not earn income or deduct losses. However, the entity itself still has reporting requirements such as the Form 1065 information return and Schedules K-1 issued to its partners and reported on the partners' respective Schedule Es. A single-member LLC in flow-through treatment (not electing C on 8832 and not electing S on 2553) does not have an income tax return to file itself. It is disregarded for income tax purposes and all items of income and loss are claimed on the single-member's Schedule C as if the member were a sole proprietor. However, if the single-member LLC has employment or excise tax obligations (Form 94X series, Form 720 series, etc), the LLC is not disregarded for these purposes and those forms are filed in the name and EIN of the single-member LLC.

The "tax nothing" aspect comes from how the LLC *is* a separate entity and normally would have to be either a partnership, C corporation, or S corporation, yet in the single member context collapses into owner's sole proprietorship as if it didn't exist for income tax purposes.

--Vince

Vincent Kan