

## **SOLE PROPRIETORSHIP vs. INCORPORATION**

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When buying or starting a new veterinary practice, a veterinarian must make an election as to what form of entity will own the veterinary practice. This decision can have serious legal and tax ramifications, and should be made before the practice is open for business. The intent of this article is to highlight the pros and cons of operating the veterinary practice in either a sole proprietorship or corporate form.

### **Sole Proprietorships**

The sole proprietorship is the simplest form of a business entity, but in many ways, the riskiest. It consists of a single, individual owner/operator who manages and controls all business operations of the veterinary practice. While many such veterinary practices operate under a fictitious business name, the sole proprietor-veterinarian remains personally liable for the obligations of the veterinary practice. If the business were to have a judgment entered against it, the individual veterinarian (unlike the corporate practice owner) would be liable for that judgment. The sole proprietor-veterinarian pays no corporate taxes, but faces taxes on income from the business as part of the individual's personal income tax obligation.

Operating as a sole proprietorship also has other disadvantages. In addition to being personally liable for all debts of the veterinary practice, the sole proprietor-veterinarian is also liable for most of the actions of his or her employees. For example, if an associate veterinarian of the owner commits an act of sexual harassment on another employee, the sole proprietor-veterinarian will also be personally liable for any resulting judgments. The sole proprietor-veterinarian is also subject to social security taxes up to the current \$94,200 limitation (as of 2006), and is further subject to unlimited liability for Medicare taxes (in contrast to corporately-owned veterinary practices, discussed below).

Finally, statistics show that the sole proprietor-veterinarian is at a substantially higher risk of an IRS audit than is a corporation!

### **Incorporation**

Many veterinarians are turning to different forms of operating a veterinary practice. In some states veterinarians are permitted to operate limited liability companies. However, California is not one of them.

A corporation is treated as an entity separate and apart from the individual practice owner. It is as if another person has been created to have ownership of the veterinary practice, but the "person" is wholly controlled by the veterinarian. Another reason businesses tend to incorporate is to protect the personal assets of the business owner. In a veterinary practice setting, if the practice fails and goes into bankruptcy, or if there is a judgment (other than malpractice-based) entered against it, the personal assets of the shareholder-veterinarian are not at risk. Unlike the sole proprietor-veterinarian, the owner of the corporate veterinary practice would not be personally liable for the malpractice of an associate.

The corporately-owned veterinary practice, operating as a Subchapter S Corporation, also realizes significant tax savings that are not available to a sole proprietor. For instance, if a veterinarian realized profits of \$100,000 in a given year, the sole proprietor-veterinarian is subject to 15.3% in employment-related taxes (i.e., Social Security and Medi-Care taxes) on the first \$90,000 in profits (\$13,770), and would be taxed at a rate of 2.9% on the remaining \$10,000, for a total in employment-related taxes of \$14,060. By contrast, if a corporately-owned veterinary practice owner operating as a Subchapter S-Corporation had the same \$100,000 in profits, the corporation could pay the veterinarian \$50,000 in salary and pay \$7,650 in employment related taxes, and the remaining \$50,000 could be distributed as a dividend on which the corporation would pay no employment-related taxes.

The corporate form of veterinary practice ownership is not without its disadvantages. A corporation pays a minimum corporate tax each year (currently \$800 in California) and must file paperwork on a yearly basis with the State in order to maintain the corporate status. The corporation must also prepare appropriate bylaws and corporate minutes and must maintain corporate minutes on an annual basis in order to protect the corporate status. The corporation must also file an additional tax return covering the corporate activities. Finally, and very importantly, an owner of a corporately-owned veterinary practice who commits malpractice remains personally liable for such malpractice. This is no different than the sole proprietor-veterinarian, who is also personally liable for his or her own malpractice.

#### C-Corporation vs. S-Corporation

In the United States, the most common type of corporation is the “C-Corporation”. The C-Corporation has the limitation on personal liability referenced above, and allows payment of employee health insurance premiums that are fully deductible. The single biggest disadvantage of a C-Corporation is that it subjects the veterinarian’s profits to double taxation. A C-Corporation’s income is initially subject to corporate income taxes on its profits, and any dividends that it pays to the shareholder-veterinarian are also taxed at the applicable shareholder’s tax rate. It is for this reason, more than anything else, that most veterinarians elect to become S-Corporations rather than C-Corporations.

The so-called “S-Corporation” provides most of the corporate advantages referenced earlier in this article. The S-Corporation is initially formed in exactly the same manner as the C-Corporation, by filing appropriate paperwork with the state in question. Unlike the C-Corporation, the veterinarian also files an IRS Form 2553, electing to become an S-Corporation. The S-Corporation is not a separate corporation, but a separate way of being treated for tax purposes. The S-Corporation in nearly all respects looks identical to a C-Corporation in that it has shareholders, a board of directors and complies with all corporate formalities. However, for federal tax purposes the corporate profits are passed directly to the shareholder –veterinarian who reports the profits on his or her individual tax return. The S-Corporation is not subject to corporate income tax. The S-Corporation makes a dividend payment to the shareholder-veterinarian who realizes a significant tax savings by not having to pay employment-related taxes on the dividend.

The disadvantages of an S-Corporation include a requirement that generally the shareholders must be U.S. citizens (certain exceptions apply for “residents”), and in order to validly form the S-Corporation, the owner must meet strict filing deadlines, failing which the corporation loses its S status. Veterinarians operating as an S-Corporation must also remember not to be too aggressive in categorizing profits as dividends in order to avoid self-employment taxes, as this can send a red flag to IRS.

#### Out-of-State Incorporation

We have all seen advertisements for seminars promising to avoid paying taxes, avoid all liability, etc. As the old saying goes “if it’s too good to be true, it probably isn’t”. An out of state corporation (a “foreign corporation”) must qualify to do business in the state where the shareholder-veterinarian practices. In most cases, the veterinarian pays the same exact corporate fees the veterinarian would pay for a corporation in the state the veterinarian is doing business in, in addition to paying all fees imposed by the state where the incorporation took place. Having the veterinarian receive all or substantially all of his or her income from the profits from the practice in the state would subject the corporation to applicable income taxes for that state, and not for the state of the foreign corporation.

The same ads mentioned above promise to keep the “real” corporate owner’s identity secret, but veterinary boards require that the veterinarian register under his or her name as the provider veterinarian for the corporation.

There is no practical advantage to a veterinarian incorporating as a foreign corporation and then practicing veterinary medicine in the state in which he or she is licensed. The veterinarian cannot avoid paying the applicable corporate fees, is subject to taxation by the state in which the veterinary practice is located, and cannot fail to disclose his or her identity as the owner of the practice. In short, it is a very poor method to utilize in veterinary practice ownership.

#### Summary

The foregoing analysis is general in nature and is not intended to apply in every situation. This article is intended to set forth the significant advantages and disadvantages of operating as a sole proprietor, a C-corporation and an S-Corporation. It is up to the individual veterinarian to make a choice as to what form of entity works best for them. I strongly urge that veterinarians utilize the services of veterinary attorneys for the pros and cons between a sole proprietor vs. a corporation and veterinary CPA’s for the election between a C-Corporation and an S-Corporation. This is a very important decision, one that could have a long lasting impact on the value of the veterinary practice, and should be made with advisors having significant experience in advising veterinarians.