

# **WHEN SHOULD A DOCTOR INCORPORATE?**

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# **When Should A Doctor Incorporate?**

We're often asked for advice about incorporating a professional practice. Here's a synopsis of the advice we normally give to our clients.

## **The options under California law are limited.**

For operating a professional medical or chiropractic practice in California, your choice of entity is limited by state law. Basically, you can have a sole proprietorship, a partnership, or a professional corporation. Somewhat by default, if one doctor opens a practice, the legal entity is a sole proprietorship. While this is the simplest form of business organization, it is also the most risky. The owner of a sole proprietorship is personally responsible for almost everything which goes on in the business...including business transactions, contractual liability, liability claims of all types, and employee claims. While some of these claims may be covered by insurance, some claims are generally not covered.

Two or more doctors can operate as a partnership, but we rarely see this type of entity in a professional practice because the partnership also carries with it full personal liability, not only for your own acts, but also for the acts of all partners.

While some states allow doctors to form various types of entities which offer limited liability (such as LLP's or LLC's), the only choice in California is the Professional Corporation (sometimes referred to as a "P.C.")

## **What is a corporation?**

A corporation is a business entity created and regulated by state law. The corporation is an independent legal entity, separate from the people who own, control and manage it. In other words, corporation and tax laws view the corporation as a legal "person," meaning that the corporation can run the business, enter into contracts, incur debts and pay taxes apart from its owners. The corporation files a tax return which is separate from the doctors who own the corporation.

## **What is a professional corporation?**

Most corporations are "general business corporations" under California law. Typically a general business corporation cannot engage in the practice of a healing arts profession such as medicine or chiropractic. California law creates a particular type of corporation called a "Professional Corporation" which is specifically authorized to practice in these fields. The corporation must be incorporated in a certain way, and can only be owned by licensed healthcare providers (See Business and Professions Code §13400 et. seq.)

## **What is "limited liability" and why is it important?**

If a business owner has "limited liability," it means that he or she is not personally responsible for business debts and obligations of the corporation. In other words, if the corporation is sued,

only the assets of the business are at risk, not the owners' personal assets, such as their houses or cars.

Each doctor still has liability for his or her own professional acts (malpractice claims). The owner, however, would not be personally liable for a general liability claim against the business, such as a patient who falls in the reception room, or people injured in an auto accident with an employee who was driving a car on company business. Even more importantly in today's legal climate, the owner would not be personally liable for employee claims against the business and for billing fraud claims, unless the owner is personally at fault.

### **Does the doctor become a corporate employee?**

Typically, yes. The doctor becomes an employee of the corporation, and is paid a base salary and bonuses, depending upon cash flow in the business.

### **How is a corporation taxed on income?**

Because the corporation is a separate entity, the corporation would typically pay tax on net income. Although this tax is at a lower rate than most individual rates for people with substantial incomes, most professional corporations avoid paying any substantial income tax at the corporate level in one of two ways.

Corporations, by default, are C-Corporations for purposes of tax treatment with the I.R.S. With a C-Corporation, the doctor usually meets with his or her accountant before the end of the tax year, and distributes remaining monies as bonuses, so that the income is taxed to the individuals and not at the corporate level.

Alternatively, the corporation can elect to become an S-Corporation, a tax election which causes all of the corporate net income to be passed through to the owners of the corporation. The corporation still files a return, but pays no federal income tax at the corporate level. S-Corporations are taxed on net income at the state level at a rate of 1.5% of net income (after the payment of all business expenses and salaries).

### **How does a professional corporation bill for the services of its doctors?**

The corporation is a separate legal entity. It obtains a new employer identification number from the I.R.S. This number, for most purposes, becomes the billing identification number. Generally, all services rendered by doctors or other types of providers employed by the corporation will be billed under the corporation's name and identification number. The individual doctor's name may also appear on the claim, but the checks generally will be made payable to the corporation.

With respect to Medicare claims, the corporation must obtain a separate provider identification number. If the corporation employs two or more doctors, the corporation must apply for a group provider identification number through Medicare.

## **What are the advantages and disadvantages of incorporation for a doctor?**

### **In summary fashion, here are the principal advantages:**

- ▶ Limited liability for the owners (discussed above) is the main advantage. Think of it as wearing a rain coat. On a sunny day, you don't need it, but in a rain storm, it comes in awfully handy.
- ▶ Ease of being able to add another doctor as an owner, even of a smaller percentage of ownership. This may be used as an incentive, and is a critical issue in making a non-compete agreement binding.
- ▶ Ease of transferring all or part of the business. The ownership of the corporation is evidenced by shares of stock.. Stock can be transferred in small or large increments quite easily, as long as the buyer is a qualified shareholder under California law.
- ▶ Under California law, a professional corporation can employ other types of health care practitioners (such as an acupuncturist, a podiatrist, a chiropractor, or a naturopath). (Corporations Code §13401.5)
- ▶ There are typically some tax advantages available in a corporate form. We urge our clients to consult with a good tax advisor about the respective tax advantages.
- ▶ Statistics show that corporate tax returns are not as likely to be audited as individual tax returns.

### **The main disadvantages of incorporation are:**

- ▶ The cost and paperwork involved in setting up the corporation. Legal fees typically run from \$1,500 to \$2,000 initially, depending upon complexity, and there will be a small charge annually for updating the corporate records. You will also have additional accounting fees, initially and each year. Although as a sole proprietorship you keep bank accounts and books separate from the owner's individual accounts, there is a separate corporate tax return which must be filed each year. In California, the minimum corporate state tax is \$800, but this amount is currently waived for the first year of operation.
- ▶ Because the doctor will be on a salary, this factor alone often forces you to do a bit more of income/expense and cash flow planning (that's not necessarily a bad thing).
- ▶ The doctor's salary may be subject to slightly higher taxes. The doctor's salary is also subject to state disability (SDI) and federal unemployment tax (FUTA) payments. State law, however, allows the owners to be exempt from workers compensation and state unemployment premiums, if they so desire.

## **How do I form a corporation?**

There are a number of steps required to legally create a corporation. The first is filing a document called "Articles of Incorporation" with the California Secretary of State. Approval by the Secretary of State brings the corporation to life. The corporation then adopts a set of bylaws, issues initial stock, appoints directors and officers, obtains a federal tax identification number, opens bank accounts, and makes the necessary provisions to begin operations. As a practical matter, we prepare all of the corporate documents, and provide the client with a checklist for the various steps which need to be done.

### **What about the State Board?**

Professional corporations are generally required to file for registration with the State licensing board. Each state licensing board has a slightly different procedure, and may require that the corporation's name meet their own name style requirements. This registration has to be reviewed every year or two.

For medical corporations, if the corporation uses a fictitious name (a name other than the name of the owner), the corporation must file a registration with the California Medical (or Osteopathic) Board.

Also, every corporation must file an annual statement of information with the Secretary of State and pay a \$20 filing fee. Again, as a practical matter, we usually take care of these "details" for our clients.

### **Is election of the S-Corporation status desirable?**

In most situations, the answer here is yes. But here, again, consulting with your tax advisor is best.

The S-election eliminates the possibility of double taxation (where profits are taxed at the corporate level, and then again to the individual when the money is distributed). Gains are passed through the corporation directly to the shareholders, and if there is a loss at the corporate level, that loss is passed through to the shareholders, to be deducted from their individual tax returns.

The S election also may allow more favorable tax treatment of some of the corporate income. The profits in an S-Corporation are distributed to the owners, but are not treated as earned income, and therefore are not subject to social security and Medicare taxes (about 15.3%). Oftentimes a part of the owner's compensation can be structured so that the salary portion is subject to social security and Medicare taxes, but the remainder of the profit is not subject to these deductions.

There are some ownership restrictions for S-Corporations, but in most professional practices, the ownership restrictions are not a problem. For example, an S-Corporation cannot have more than 75 shareholders, and each shareholder must be an individual who is a resident or citizen of the United States. The corporation must use the calendar year as its fiscal year, and cannot have more than one class of stock. These requirements fit fairly easily within the structure of most professional practices.

## **How do you determine if a doctor should incorporate?**

We believe the best solution is to incorporate a practice right from the start. Because the biggest drawback is the expense, doctors who are just starting out or who are still somewhat unsure of their future, may be hesitant to incur this additional expense. However, if you're setting up your own practice, (either individually or jointly with others), it's far easier in the long run to establish the corporation right from the beginning. While changing the form of entity a few years down the road is possible, it's oftentimes more difficult because you then have an ongoing business which changes its' identity, tax i.d. number, provider numbers, and provider contracts.

If the doctor is working for someone else, or is sharing space and has no employees, incorporation is typically not necessary. But where the practice is busy, with several employees, incorporation is desirable. When the practice is hiring other doctors, incorporation becomes particularly important for liability reasons.

Where multiple doctors associate together to practice in a group, incorporation becomes essential. Here there are only two options, partnership and incorporation. In a partnership, each partner is fully liable for all acts of the partnership and of his or her partners. While it is possible to have a partnership composed of several single doctor corporations, this adds substantial expense and complexity. The most common form for doctors practicing in a group is therefore the professional corporation, with multiple shareholders. The use of a single legal entity (either a partnership or corporation) is essential to the ability to refer patients to each other and to profit from the overall income of the business because the group must meet the requirements of the group practice exception under both federal and state self-referral laws.

## **How long does it take to incorporate?**

The incorporation process can be handled quickly, taking about a week to ten days. However, the rest of the process, which includes obtaining provider identification numbers, and registration of a fictitious name (if the name of the corporation is other than the name of the shareholder) with the Medical Board typically takes an additional 30 to 90 days. Medicare is usually the slowest in issuing the provider number, but does allow the corporation to bill retroactively to the date on which a "complete" application form is submitted.

Because the process does take some time, it's important to plan ahead and get started well in advance of the target date for actually opening the practice or switching to a corporate form.

**THIS MEMORANDUM CONTAINS A GENERAL DISCUSSION OF LEGAL PRINCIPLES APPLICABLE IN CALIFORNIA AS OF JANUARY 1, 2007. IT SHOULD NOT BE TAKEN AS SPECIFIC LEGAL ADVICE. PRACTICE STRUCTURE AND OPERATIONAL ISSUES HAVE BECOME LEGALLY COMPLEX DUE TO SIGNIFICANT AMOUNTS OF GOVERNMENTAL REGULATION. WE URGE EACH DOCTOR TO CONSULT WITH A COMPETENT HEALTH CARE ATTORNEY ON THESE AND OTHER ISSUES AFFECTING THE PRACTICE OF THE HEALTH PROFESSIONS.**

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