

Legal Aspects of a Professional Consulting Practice

THRESHOLD CONSIDERATIONS

- operate alone or with partner(s)?
- from home or leased office space?
- legal form in which to operate
- filings related to formation
- owners agreement: what is the deal among the owners?
- liability
- taxes and tax filings: federal, state, and local

OVERVIEW

- Alone or with others
 - vicarious liability for acts of other owners?
 - impacts insurance considerations and choice of legal form
 - owners agreement
 - buy-out on death, disability, incapacity, bankruptcy, divorce
 - compensation decisions and profit/loss-sharing
- management control and strategic decision-making

Where to operate

- do you need an office outside the home?
 - meeting clients – their place or yours?
 - image (and myth) – changing perceptions with explosion of freelancing enhanced by computers and web-based business
 - employees?
 - do they need an office to report to?

Rented office space

- lease negotiation
- overhead: rent, utilities, additional insurance
- greater liability unrelated to performance of services
- limited term: move every X years?
 - eventual purchase?

Home office

- negative rent: home office deduction
- zero commute time, expense
- careful recordkeeping re expenses (e.g., phone, utilities) allocable to home office
- special IRS form included with tax return
- higher audit risk for self-employed at home

Website: do you need it?

- Becoming independent credential
- Source of [global] business
- care needed to avoid tripping into liability because of online “advice”
- use disclaimers

Legal form – “choice of entity”

- impacts tax liability and tax returns, liability, filings and documentation related to formation and ongoing maintenance
- traditional trade-off : limited liability [corporation] vs. simplicity and tax advantages [proprietorship or general partnership]
- limited partnership : limited liability, favorable taxation – but at the cost of complexity
- limited liability company : limited liability, favorable taxation, simpler than limited partnership, frequently better alternative than corporation for sole owner

–ALL business-owners must make quarterly payments of federal and state income tax and federal retirement/disability contributions [FICA/SECA]

–if multiple owners, **decision authority** can be separated from **economic interest** [*e.g.*, non-voting stock, limited partnership interest]

SELECTING A LEGAL FORM: The Choices

- if alone [with or without employees]
 - sole proprietor
 - corporation
 - limited liability company [LLC]
- if with “partners” [with or without employees]
 - general partnership
 - limited partnership
 - limited liability company
 - corporation

Sole Proprietorship -- one owner

- formation filings: none, unless file a d/b/a to register a name other than your own – *fictitious name filing*
 - rules on what names are permissible
 - e.g., in PA, *cannot* use “corporation,” “Inc.,” or “limited” [“Ltd.”]
 - » *can* use “company”
 - real-world example for a consultant client: “X University”
 - » impermissible since the owner was not an educational institution meeting specified standards
 - employer identification number [EIN] if there are employees

- organization documentation: none
- third-party agreements
 - GET A LAWYER and an ACCOUNTANT!
 - engagement letters spell out terms
 - vendors – usually supply their own form; limited, if any, negotiation

Clients: engagement letter

- separate contract for each engagement
- a blanket form if recurring similar engagements is likely – attach a schedule for each engagement
- scope of engagement: specify precisely what services will and will not be provided
- payment terms: amount and time of each payment under the contract

Engagement letter (cont'd)

relationship to client

- independent contractor
- no employee, partner, co-venture arrangements
- exit options for each party
- what constitutes default
- limit liability and damages

Engagement letter (cont'd)

- rights of each party
- arbitration or litigation?
- jury?
- what state? Which state's law?
- term of agreement: precise beginning and ending points
- boilerplate [NOT unimportant – just standard]

Liability: UNLIMITED

- **purchase general liability insurance**
- **possibly “errors and omissions”**
- **use disclaimer clauses in client contracts**
 - » **“Consultant shall have no liability to Client or any other individual or entity for damages resulting directly or indirectly from implementation of recommendations provided under this contract.”**
 - » **“In no event shall Consultant be liable for punitive or exemplary damages sought by Client or any other individual or entity, even if partially or wholly directly attributable to the negligent act or omission of Consultant or its agents.”**
 - » **Client liable for consultant legal fees if client sues and loses**

Liability (cont'd)

- **unemployment compensation insurance for employees**
- **property insurance**
- **disability**
- **business interruption**
- **life**
- **errors and omissions**

Taxes

- report income from consultancy on **Schedule C**, filed with Form 1040
 - show receipts, expenses, net income
 - result reported on a separate line for business income on first page of 1040
 - a separate Schedule C must be filed for each business – e.g., yours and your spouse's

No employer withholding means:

- proprietor must make quarterly estimated federal, state, and local tax payments, each reported on separate form
- in lieu of Social Security and Medicare taxes withheld by employer, proprietor must make direct payments to enter into the computation of the proprietor's government-provided retirement/disability income

Employment Tax --Terms

- “SECA”: Self-Employment Compensation Act
 - counterpart to the Social Security Act “FICA”
 - Federal Contributions Insurance Act
- “NESE”: net earnings from self-employment
 - The portion of self-employment income subject to SECA tax
 - excludes income of the business not derived from consulting services [e.g., rent, dividends, interest, property sales]



SECA

- reported on Schedule SE
 - deduct one half
- RATE: 15.3% [10.4% for 2011]
 - 12.4% SS tax on the first \$106,800 of NESE
 - 2.9% Medicare tax on ALL NESE
- Compare W-2
 - 7.65% for each of employer and employee on W-2 [2011: 6.2% employer, 4.2% employee]
 - all withheld by employer

Retirement and Benefit Plans

- You have to create your own
- Retirement
 - IRA
 - Keogh [“HR 10”]: profit-sharing
 - SEP [“Simplified Employee Pension”] for self and/or employees

Health Plans

- Medical Savings Account
 - Must be grandfathered by participation in such a plan before 2008
- Health Reimbursement Plan
 - Employer-based
- Health Savings Account
 - Portable, but available only for those in “high-deductible” health plans

Other Considerations

- proprietor with employees may need to make unemployment contributions
- note that the rules for determining taxable income differ for federal, state, and local purposes

Corporation – one or more owners

- big advantage: limited liability [with exceptions]
- big disadvantage: corporate tax + owner tax [with exceptions]
- choices: C corporation or S corporation

C corporation

- pays its own tax, in addition to the tax on any dividends paid to shareholders
- Files **Form 1120** [and counterpart state forms]
- usually, a local “business privilege tax” in lieu of the “earned income tax” applicable to employees and self-employed

Corporation (cont'd)

- can deduct, among other business expenses,
 - reasonable compensation paid to employees [including owner-employees]
 - for a consultancy, virtually all income paid to a sole shareholder is deductible
 - So only one income tax is paid – by the shareholder
 - Exception for goodwill, separable from consultant (though initially created by consultant)
 - Consultant's or corporation's property?
- taxes other than income taxes may apply to the corporation
- – e.g., excise taxes, capital stock tax

Corporation (cont'd)

- if there are multiple shareholders, payments to those who are investors only -- not employees -- will not be deductible and will therefore be subject to a second tax on the payee
 - Dividend tax: under current law, generally taxed at favorable capital gains rates

Corporation (cont'd)

- corporation withholds and pays income tax based on employee compensation and claimed exemptions
- corporation withholds and pays Social Security [“FICA”], Medicare tax, and unemployment compensation contributions

Corporation (cont'd)

- corporation can establish retirement and other benefit plans, including deferred compensation plans not subject to the stringent requirements applicable to pensions and other “qualified” plans [e.g., profit-sharing, 401(k)]

S corporation

generally, no separate corporate income tax
for federal or state purposes

-- city and local jurisdictions may vary

instead, each shareholder gets a Schedule K-1
showing shareholder's share of income
other than the shareholder's compensation

S corporation (cont'd)

- other rules applicable to C corporations generally also apply to S corporations
 - except for retirement and benefit plans
 - some special rules limiting deductions for certain shareholder-employees

S corporation (cont'd)

- generally, only US individuals, certain trusts and estates, 501(c)(3) organizations, and qualified retirement plans are permitted to be SHs
- no more than 100 SHs

S corporation

COMPLEX!

Consult a tax specialist

Limited liability

- a corporation is a legal entity separate from any shareholder
- its liability is separate from that of its shareholders, who are shielded from liabilities of the corporation to customers, vendors, and others, provided certain formalities are observed [e.g., keep records of meetings, separate bank account, conduct business in corporation's name – on contracts, letterhead, bus cards, phone]

Limited liability (cont'd)

- corporation may still want to obtain general liability and E&O insurance and limit liability in contracts with customers and vendors

Filings

- formation: register with state
- election for subchapter S treatment [if applicable]
- EIN [employer identification number]
- quarterly estimated tax payments
income, Social Security, unemployment

Documentation

- For single owner, possibly an employment contract between the employer-corporation and the employee-shareholder
- For multiple owners, a shareholders agreement is *de riguer*
 - restrictions on transfer
 - buy-back/-out on retirement, separation/termination, death, disability, incapacity, bankruptcy, divorce

Employment agreements with consultants

- evidences employee's acting on behalf of corporation – a corporate asset/liability
- protects employee if fired without cause
- key terms: duties, term, fringe and other benefits, vacation, sick leave/disability
- frequently, covenant not to compete, confidentiality of proprietary information, non-solicitation of company employees post-separation, ownership of invented items, use of company property
- VERY important: frequent source of post-separation litigation

Partnership – at least two owners

- big advantages over corporation
 - no entity income or capital stock tax
 - owners only pay income tax
 - fewer filing requirements
 - flexibility
 - change income-sharing from year to year
 - share losses differently from income
 - possible tax advantage in loss years where borrowing is involved

Partnership (cont'd)

- possible disadvantage:
 - give up limited liability to get simplicity and flexibility

General or limited partnership

- General pshp: all general partners
 - like a co-venture of sole proprietors
- Limited pshp: at least one GP and one LP

General or limited (cont'd)

- usually, LP is passive investor [“silent partner”]
 - atypical for a service business like consultancy
 - typically, no say in management or operations
 - may negotiate terms more like a lender
 - like a permanent lender, but with right, possibly, to share in profits rather than interest

General or limited (cont'd)

- one person can be both a GP and a LP
- Why do that?
 - possible SECA advantage
- as GP, has unlimited liability [see below]

What's at stake?

- unlimited vs. limited liability
- general partner: same as sole proprietor – unlimited personal liability for liabilities of business
 - in addition, “vicarious liability”: every GP liable for acts of all other GPs
 - can contractually limit, but not as to third parties

What's at stake?

- limited partner: similar to shareholder
 - fewer rights than SH in some ways
 - less access to company information
 - possibly no voting power at all
 - Generally, no voting on general partner (by contrast to annual election of corporate directors)

What's at stake?

- Limited partner (cont'd)
 - better protection from creditors than SH
 - creditor has right only to whatever distributions GP decides to make, subject to fiduciary obligation to LPs
 - generally can't compel distributions , but some inconsistency on this among the states

Limited partner (cont'd)

- tax due on share of income, even if no distribution
- same issue for departing LP: possible K-1 income greater than cash distributed for period through departure date

Formation filing

- general partnership
 - maybe fictitious name
 - does not prevent use by others
 - EIN if employees
- limited partnership
 - EIN if employees
 - limited partnership certificate, similar to corporate charter
 - no need for fictitious name
 - name cannot be used by others for entities within the state

Limiting GP Liability

- GP of limited partnership has unlimited liability
 - remedy: incorporate the GP -- limited liability
 - alternative: GP as LLC [or even a second ltd pshp]
 - Downside:
 - two sets of formation filings
 - two annual federal and state tax returns

Partnership: owner document

- Partnership agreement
- generally, same considerations as SH agreement
- additional tax provisions required

Partnership (cont'd)

- quarterly estimated tax payments
 - each partner must make own payments
 - special considerations if partners from different states

Partnership: employment taxes

- GP: self-employed – SECA tax on NESE
 - a partner cannot be an employee of own partnership
- LP: no employment tax, unless also a GP or employee
- for non-partner employees: FICA withholding

Partnership: income tax

- no income tax liability for partnership
- all income or loss goes to partners
 - shown on Schedule K-1 for each partner
- some of the items of income or loss shown on K-1 get reported on Schedule E [Supplemental Income/Loss], which then gets transferred to first page of Form 1040

Limited Liability Company

- one or more owners
 - advantages: one tax, flexible, limited liability
 - no entity-level income tax unless owners elect to have LLC treated as a corporation for income tax purposes
 - may be state capital stock tax
 - limited liability for all owners and managers
 - same flexibility as a partnership

Taxation

- if one owner, same as sole proprietorship
- if multiple owners, same as partnership
- can elect C or S corporate tax treatment

Formation filings

- similar to limited partnership
- EIN
- name protected against use by another as entity name within the state

LLC (cont'd)

manager does not need to be owner

- similar to corporation
[non-owner officers and directors]
- different from partnership [GP]

OTHER GENERAL CONSIDERATIONS

- special considerations if foreign income or foreign owners
- entity, product, and service names – trade names, trademarks, service marks, patents, copyrights
 - different from fictitious name or entity name

Considerations: estate planning

- leaving (an interest in) the business to spouse, children, relatives
- possible gift/estate tax advantages to transfers of minority interests
- can transfer economic interest without voting rights (or *vice versa*)
- can transfer to minors – in trust or custodial account

Other considerations (cont'd)

- key-man insurance -- used to buy new talent on death of founder or other key employee
- equity incentives to key younger employees -- tends to be favored over mere bonuses, profit-sharing plans
- succession planning: lining up new owner(s) to help pay for retirement

Other considerations (cont'd)

- might be reasons to have more than one business entity
 - e.g., own a building in one entity, which leases space to another entity which conducts the business
- crossing state lines: required filings

SUMMARY

- legal and tax issues attach to all major decisions, including:
 - whether to operate alone or with co-owners
 - where to operate
 - accepting/terminating an engagement

Summary (cont'd)

- selecting a legal form – considerations:
 - limit personal liability
 - minimize tax liability
 - consider estate planning/business succession
 - filings and maintenance documentation

Summary (cont'd)

- flexibility, simplicity
- bringing in new members
- rearranging ownership and profit-sharing
- Borrowing
- governance [GP, directors, manager]

Summary (cont'd)

- documentation
 - related to entity formation
 - basic services contract/engagement letter
 - (present or future) owners agreement
 - employment agreements, covenants not to compete, nonsolicitation, nondisclosure
 - ownership of inventions, intellectual property

Summary -- documentation

- business loans
- follow-up letters: “document trail”
- billing

Summary (cont'd)

- Insurance
 - general liability
 - errors & omissions
 - property
 - business interruption
 - disability
 - life

Summary -- Taxes

- federal, state, and local income tax
 - corporation: 1120 or 1120-S
 - LLC/partnership: 1065
 - Solo/SMLLC: Schedule C for 1040
- capital stock tax? franchise tax?

RESOURCES

IRS Publications

334 TAX GUIDE FOR SMALL BUSINESS (FOR
INDIVIDUALS WHO USE SCHEDULE C OR C-EZ)

535 BUSINESS EXPENSES

583 STARTING A BUSINESS AND KEEPING RECORDS