# structuring firms to manage risk

*Time was that if you were going to set up a professional practice, how you organized it was pretty simple. If you were going to practise on your own, you were a sole practitioner, or perhaps practising in association with one or two others. If you were going to practise with other lawyers, you formed a general partnership. Either way, you had unlimited liability for claims against the practice, whether or not you, personally, were at fault. And you paid tax on all your income at regular personal tax rates.*

*Times have changed and so have the ways in which you can organize your practice.*

*Legislative changes in the Law Society Act, R.S.O. 1990, c.L.8, Business Corporations Act, R.S.O. 1990, c.B.16 and Partnerships Act, R.S.O. 1990, c.P.5 now let you tailor your firm structure to better suit your needs and circumstances.*

*Today your practice choices are many: You can now also practise through professional corporations, limited liability partnerships, and multi-discipline partnerships – or in some combination.*

*These new choices create risk management opportunities, which should be taken into account when setting up practice for the first time or when restructuring an existing law firm. As well, tax benefits can now be particularly significant for those practising alone or in small numbers.*

*In this issue of LAWPRO magazine, we examine the many firm structure choices available to lawyers – and the liability and tax issues associated with each.*

# Liability and law firm structures

## Sole proprietorships

The number of lawyers practising as sole proprietorships is expected to drop significantly in Ontario, as lawyers become more familiar with the tax advantages associated with practising in professional law corporations, alone or perhaps with others.

A sole proprietorship, however, remains a simple and convenient form in which to conduct the practice of law. No separate legal entity is involved: The sole proprietorship is an extension of the natural person. The business, its assets and liabilities, are that of the owner. And like other legal entities, a sole proprietor can have employees and agents, and is responsible for their acts through agency and employment law.

One very important risk management benefit to a sole proprietorship is the opportunity to directly control risks associated with the practice. The owner is responsible for his or her own practice. He or she also directly supervises any employees or agents and can ensure first-hand that they understand and take effective steps to address risks and exposures relating to the practice.

On the down side, the owner faces unlimited liability, and there is no separation between business and personal matters. So, without taking other steps, your personal assets are exposed to payroll, lease and other business obligations, and the business is exposed to any personal or family obligations.

With unlimited personal liability, maintaining adequate insurance protection is very important, including adequate professional liability insurance for the practice, appropriate general liability and office coverages, and fidelity coverage for the acts of employees and agents.

## Practising in association

For a variety of reasons, many lawyers choose to associate with other lawyers in practice, without entering into any type of partnership arrangement or a professional law corporation.

They may want to offer the client a greater sense of firm profile, resources or available expertise; or recognize work referral arrangements; or ensure easy access to others to confer and rely upon; or reduce expenses by sharing office and meeting space, reception and administrative facilities, and costs of support staff.

Although associations, as well as partnerships, with non-lawyers are also a possibility, there are limitations on when they may be formed, and significant professional obligations that apply. These are discussed under "Multi-discipline practices" on page 4.

Despite the risk management and other benefits of working in association, lawyers in these practice arrangements should take precautions to ensure that they do not inadvertently assume any liability for risks associated with the others' practices.

As well as buying insurance, a lawyer practising in association needs to manage the "ostensible partner" exposure – likely the single most important aspects of risk management for lawyers practising in association. (For more, see page 5). As well, lawyers must remember that they may have less ability to control and oversee staff when they share resources with other lawyers.

## General partnerships

The number of lawyers practising in general partnerships is declining rapidly, as firms adopt other new firm structures, such as limited liability partnerships.[1]

A partnership is the relationship between persons carrying on a business in common, other than in a corporation, with a view to profit. The partnership does not require any specific formalities. However, lawyers should have in place a written partnership agreement to: manage expectations; address the varying degrees of participation of partners; document their interests, duties and responsibilities; and deal with specific events such as the admission of new partners and the withdrawal of existing partners under various circumstances.

Under the *Partnerships Act*, every partner is an agent of the partnership and of the other partners for the purpose of the business of the partnership, and the ordinary acts of each partner will generally be taken to bind the firm. Similarly, acts done or instruments executed by partners and others authorized on behalf of the firm concerning firm business bind the partnership.

Unless they are in a limited liability partnership, every partner in the firm is liable jointly with the other partners for all debts and obligations of the firm incurred while the person is partner. Wrongful acts or omissions, misapplications of money or property

1 LawPRO statistics indicate that in 2003, close to 40 per cent of the 19,400 lawyers in private practice worked in an LLP.

received for or in the custody of the firm, done in the ordinary course of business, all bind the general partnership and its partners.

Because ownership and control reside with all partners together and not one individual, and because each partner faces unlimited liability on a joint and several basis for the acts of all partners, employees and agents, the stakes facing each partner are substantial, and the risks are more difficult to manage. Internal procedures and controls are critical in effectively managing your practice exposure with this type of practice structure (for a detailed listing of internal controls and procedures, see pages 6-10 in practicePRO's *managing the finances of your practice*. www.practicepro.ca/financesbooklet).

## Limited liability partnerships

The number of limited liability partnerships has grown quickly in Ontario since the necessary changes in the *Partnerships Act* and By-Law 26 of the *Law Society Act* came into force in 1999.

A limited liability partnership has the characteristics of a general partnership, but with specific limitations on the liability of partners. Unlike in a general partnership, a partner in a limited liability partnership is not jointly liable for the debts, obligations and liabilities of the partnership arising from the negligent acts or omissions of another partner or of an employee, agent or representative of the partnership, committed in the course of partnership business.

In fact, other partners are not a proper party to such proceedings. Instead, a lawyer is only personally liable for his or her own negligence, and for the negligence of any person under his or her direct supervision or control. Of course, claimants may seek to make others in the LLP personally liable, alleging that other partners ought to have exercised some measure of supervision or control, or perhaps should have implemented procedures to avoid the negligence of others.

Clearly, these limitations on your personal liability are a very important benefit as you look to manage the risk exposure associated with your practice. However, the limited liability partnership itself continues to be fully exposed for the acts of all of its partners, employees and agents, so any assets you have in the firm itself would remain at risk.

If the liability does not arise out of negligence, all partners in a limited liability partnership continue to be fully exposed. So all partners remain fully liable for any non-negligent breach of firm obligations, including failure of the firm to meet its lease and payroll obligations, as well as for any wrongful acts or omissions, or misapplications of money or property placed in the custody of the firm in the ordinary course.

Whether new or amended, the partnership agreement must be in writing, designating the partnership to be a limited liability partnership and providing that the *Partnership Act* shall govern. In continuing a partnership as a limited liability partnership, the limited liability partnership and its partners become liable for all debts, obligations and liabilities of the partnership and its partners arising before the continuance.

Even for limited liability partnerships, insurance remains an important consideration. Clients are anxious to know that there is ample insurance protection backstopping your firm's services, appreciating the restricted access to partners' personal assets. As a partner, you face personal liability for your own negligent acts and those of any person under your direct supervision or control. You are also jointly responsible for the non-negligent acts of all others in your firm, and for any liabilities subsequently arising out of past services you provided to the firm during your tenure with the firm before it became a limited liability partnership. Of course, your assets in the partnership remain fully exposed for the activities of all others in the firm, and indeed, any predecessor partnership.

## Multi-discipline practices ("MDPs")

Approval in 1999 of By-Law 25 of the *Law Society Act* enables lawyers to participate in multi-discipline practices.

The MDP model approved by Convocation allows lawyers to enter into a partnership or association with a non-lawyer who practises a profession, trade or occupation that supports or supplements the practice of law, to permit the lawyer to provide these services to his or her clients. Fully integrated MDPs offering a full range of services for clients are not allowed under the By-Law.

Effective control over the non-lawyer's practice of his or her profession, trade or occupation as it relates to the partnership or association, must remain with the lawyer. The non-lawyer must acknowledge this, and agree to certain limitations on his or her trade practice, including that he or she be bound by the *Law Society Act*, its regulations, by-laws, and rules of practice and procedure. The rules, policies and guidelines on conflicts of interest apply in the case of an MDP partnership.

This model provides lawyers with an opportunity to offer a more complete service to their clients, allowing patent and trade mark agents, tax consultants, public policy advisors, human resources consultants, and others to enter into an association or partnership with you.

# Is yours a true association or apparent partnership?

Under section 15 of The *Partnership Act*, R.S.O. 1990, c. P.5 lawyers practising in association may be exposed to vicarious liability for the acts of their associates, where there has been a "holding out" of partnership and the client relies on this holding out.

> "15. (1) Every person who by words spoken or written or by conduct represents himself or herself or who knowingly suffers himself or herself to be represented as a partner in a particular firm, is liable as a partner to any person who has on the faith of any such representation given credit to the firm, whether the representation has or has not been made or communicated to the persons so giving credit by or with the knowledge of the apparent partner making the representation or suffering it to be made."

Seemingly the courts have interpreted "giving credit" to include virtually any professional dealing. They have tended to look at the whole of the circumstance, and have looked to the following in determining whether or not the association is a true association or an apparent partnership:

- name on the firm letterhead or stationery;
- signage on the firm's door and elsewhere;
- wording on business cards;
- public announcements and advertising (e.g. Ontario Reports, yellow pages);
- premises and resources shared;
- use of the firm name in pleadings;
- shared or separate bank accounts.

Other issues that you should consider include:

- your firm's promotional materials, including web pages;
- how client referrals are handled among associates;
- how files and billings are treated when associates are called to assist;
- how reception answers the telephone and greets clients;
- what you and staff say and how you conduct yourselves with clients;
- your course of dealings with the client.

LAWPRO recommends that letterhead and other material referencing the association specifically state that you are acting in association and "not in partnership". In *Bet-Mur Investments Limited v. Spring et al* (1994), 20 O.R. 417 (Ont.Ct.Gen.Div.), affirmed [1999] O.J. 342 (Ont. C.A.), the Court held that in the circumstance where the letterhead and the sign on the door suggest that the solicitors may be partners, the solicitors bear the onus of conveying to the public that they are not partners.

From a risk management perspective, however, you need to be aware that **you are responsible** under the by-law for ensuring that the non-lawyer practises his or her profession, trade or occupation with the appropriate level of skill, judgement and competence, and complies with the *Law Society Act*, regulations, by-laws, rules, policies and guidelines. This is regardless of whether it is an association or partnership arrangement. So, in either case, the importance of effective risk management and controls, and insurance, in the context of MDPs is clear.

## Professional law corporations

Amendments to the *Business Corporations Act*, R.S.O. c.B16, the *Law Society Act*, and Convocation's approval of By-Law 34 in 2001 allowed Ontario lawyers to practise law through professional law corporations.

Many Ontario lawyers practising alone or in small firms are now incorporating their practices so that they can realize the tax savings that apply to these practices, as described on page 8. Although it is possible for larger firms to use professional corporations in their structure, the tax savings are effectively shared among all in the firm, so the tax advantage quickly diminishes with more than a few in the firm.

Like other types of corporations, a professional corporation is a legal entity, separate and apart from its shareholders. A professional corporation, however, may only be owned and operated by members of the same profession, and may not carry on a business other than the practice of the profession, or activities related to or ancillary to the practice of that profession.

From a risk management perspective, lawyers need to remember that many of the traditional protections against personal liability associated with the use of a corporate entity DO NOT exist in the case of professional corporations.

In particular, the *Business Corporations Act* provides that:

(a) the acts of a professional corporation are deemed to be the acts of the shareholders, employees or agents of the corporation;

(b) the liability of a member for a professional liability claims is not affected by the fact that the member is practising the profession through a professional corporation;

(c) the shareholders are jointly and severally liable with a professional corporation for all professional liability claims made against the corporation for errors and omissions that were made or occurred while a shareholder; and

(d) if a professional corporation is a partner in a partnership or limited liability partnership, the shareholders have the same liability for that partnership as they would if they themselves were the partners.

Therefore it is as important for professional law corporations to have effective risk management and insurance protection in place as it is for other types of firm structures.

## Combined firm structures and management companies

In structuring their law practices, a number of lawyers are also combining these practice forms, as well as continuing to make effective use of management companies.

For example, some small firms are choosing to become limited liability partnerships with one or more firm lawyers forming personal law corporations which act as partner. In doing so, these lawyers look to achieve the benefits of limited liability protection through the firm partnership, and share in the tax benefits by having his or her personal professional law corporation act as partner.

Similarly, lawyers have elected to practise in general associations or partnerships while using personal professional corporations. Other law firms have elected to form multi-discipline partnerships while realizing the benefits of a limited liability partnership.

Of course, many law practices continue to limit the scope of the activities of the law firm itself to the provision of legal services by lawyers, while providing other services and conducting various administrative functions in common corporations.

In this situation, intellectual property, ADR and other types of services are provided through a corporation at the side, and management companies are formed to deal with lease, payroll and other obligations.

These corporations are formed for many reasons, including to provide principal stature to non-lawyers in the firm, to facilitate income splitting, to provide services that are not incidental to the practice of law, and to limit personal liability.

By assessing their objectives and identifying the opportunities available, more than ever lawyers are able to tailor their firm structure to suit their practice and personal needs.

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# A taxing question: The tax implications of different firm structures

## Sole proprietorship and lawyers in association

This is the one type of business structure that has not changed significantly in recent years. From a tax perspective, working alone or in association may be an excellent option for those just starting out in practice, perhaps working part-time or out of their home. Your net professional income, essentially fees billed less practice expenses, is included in your income for tax purposes. If you operate your business from your home, you can deduct a reasonable proportion of your home office expenses. You must calculate your professional income on a calendar year basis. As well, you have the option of realizing additional tax benefits from incorporating as a professional law corporation, as discussed later in this article.

If you decide to work with a group of other professionals (either in association with other lawyers, or with non-lawyers as an MDP) sharing office, secretarial and other costs, you can still operate as a sole practitioner, for tax purposes. However, once the arrangement moves to one in which you share profits rather than costs, you will need to consider one of the other two structures described below.

## Limited liability and other partnerships

Since 1999, when changes to the *Law Society Act* and By-Law 26 came into effect, lawyers have been able to carry on professional practice through a limited liability partnership (LLP). Prior to that, professionals could carry on practice only through a general partnership (GP) which brought with it all the problems of joint and several liability. Most professional law partnerships in Ontario have now converted into LLPs which, from a tax perspective is the preferred method of carrying on practice[1]. Carrying on business through a partnership, whether a GP, an LLP or MDP, has a number of tax implications:

- Partnerships are not considered separate legal entities and are therefore not subject to tax. Profits are calculated at the partnership level, applying the normal tax rules, and are then allocated proportionately among the partners, who each pay their own tax.
- Provided the partnership files the appropriate election with CCRA, there is no need to place a value on work in progress in the calculation of income. This means that, for tax purposes, income is recognized when a fee is billed and not when the time is docketed or recorded.
- A partnership must adopt the calendar year as its fiscal period.
- For tax purposes, a partner's interest in a partnership is treated as an asset separate and distinct from the underlying assets of the partnership. As with any other asset, an interest in a partnership has a cost base for tax purposes which must be tracked. The cost base is increased by contributions of capital to the partnership plus the partner's share of income computed on a tax basis, and reduced by drawings on account of income or capital. When a partner disposes of his or her interest in the partnership upon resignation or retirement, a capital gain or loss may result because of differences in the calculation of income for book and tax purposes.
- A partnership offers maximum flexibility in structuring the ownership interests of the individual partners. Interests can be changed to reflect changes in the profit contributions of individual partners. It is also possible to have income interests in different proportions to capital interests.
- Special rules in the tax legislation permit partnerships to allocate profits to former partners, which eases the transition when partners retire or withdraw from the partnership.
- The one major tax disadvantage of a partnership is that all profits are taxed currently in the hands of the partners and

[1] LawPRO statistics indicate that in 2003, close to 40 per cent of the 19,400 lawyers in private practice worked in an LLP.

there is no opportunity to reduce or defer tax, as there is with a corporation (see below). However, profits of the partnership taxed in the hands of the partners are considered to be earned income for the purposes of calculating an individual's ability to contribute to an RRSP, provided the partner is "actively engaged in the business".

- As far as the individual partners are concerned, they are treated as being self-employed for tax purposes, which means that they contribute to the Canada Pension Plan but they do not have to pay Employment Insurance (EI) contributions nor, in Ontario, the Employer Health Tax (EHT).
- The partnership, and not the partners, must obtain a business number from CCRA, for GST and payroll withholding purposes. The partnership must also file an annual information return on form T5013 with CCRA and issue each partner an information slip showing the amount of income to be reported on the partner's individual income tax return.

## Professional corporations

Since 2001, lawyers and certain other professionals in Ontario have been able to carry on practice through a professional corporation (PC). While a PC does not provide any additional liability protection in respect of professional risk, it offers a wholly different set of tax planning opportunities.

The Canadian tax regime has always provided a favourable tax environment for a small business corporation, technically known as a "Canadian-Controlled Private Corporation" or CCPC, by providing a significantly reduced tax rate on the first $200,000 of annual income. Until recently the setting up of a corporation was denied to most professionals. Not only did the law change to allow the setting up of PCs but the tax benefits were also enhanced, for all CCPCs, by a reduction in the tax rate and a raising of the threshold to which the reduced tax rate applied.

Currently, in Ontario a tax rate of 18.6 per cent applies to the first $225,000 of annual income and, by 2006, the rate will be reduced to 17.1 per cent on the first $300,000 of annual income. How does this impact your professional practice?

Corporations are taxed quite differently when compared to partnerships and their partners:

- A corporation is a separate legal entity and taxed independently from its shareholders.
- If a practitioner wishes to withdraw funds from his PC, he can either receive the money on a pre-tax basis as a salary or bonus, or on an after-tax basis as a dividend. The difference is that a salary or bonus reduces the taxable income of the corporation and creates an equal amount of taxable income in the hands of the recipient, while a dividend is paid out of the after-tax income of the corporation. Although a dividend is taxable in the hands of the shareholder, the shareholder is given credit for part or all of the tax paid at the corporate level. The following illustrates the tax impact of paying a salary or dividend out of a PC to its owner/shareholder.

| | | Salary | Dividend |
|---|---|---|---|
| **PC** | Revenue | 1,000 | 1,000 |
| | Salary paid | (1,000) | – |
| | Taxable income | – | 1,000 |
| | Corporate tax | – | (186) |
| | After-tax income | – | 814 |
| **Individual** | Salary/dividend received | 1,000 | 814 |
| | Dividend gross-up | – | 203 |
| | Taxable income | 1,000 | 1,017 |
| | Federal & Ontario tax | 464 | 255 |
| | After-tax income | $536 | $559 |

There are two interesting points to note from this example. First, of the $1,000 profit earned in the PC, $186 goes in taxes

and $814 can be reinvested in the business. Second, even when profits are withdrawn from the business, the combined effective tax rate is 2.3 percentage points lower than it would have been had the income been withdrawn as a salary, and the shareholder receives an additional $23.

- If you are a sole practitioner, you can set up a PC to carry on the practice and enjoy the full benefit of the small business rate. If you are in practice with one or more other professionals, you can still use a PC to carry on the practice, but you have to share the benefits of the small business rate, and the more practitioners you have, the smaller each person's share of the tax reduction.
- Once the PC's income exceeds the amount eligible for the small business rate, the combined tax rate in the corporation increases to about 36.6 per cent (reducing to 31.6 per cent in 2005). It then becomes tax inefficient to pay tax in the PC and distribute the after tax income as a dividend. At this point it is more tax efficient to pay a salary or bonus to the practitioner to reduce the PC's income down to the level of the small business rate.
- Most practitioners should ensure that they have sufficient income to maximize their RRSP contribution. This requires approximately $80,500 of earned income to generate an RRSP contribution of $14,500 (the maximum in 2003). Salary or bonus constitutes earned income, a dividend does not. A salary or bonus at this level will also cause maximum CPP contributions to be made.
- While EI contributions are not required on a salary you receive from a corporation you control, if total salary and bonuses paid by the PC exceed $400,000 the PC will be liable to EHT up to an amount not exceeding 1.95 per cent of its payroll.
- Unlike other corporations, a PC is required to use a December 31 year end for tax purposes.
- If the PC is in the position of reducing its taxable income by paying a bonus, a small measure of tax deferral can be achieved by accruing the bonus as an expense in the corporation in one year and paying it to the practitioner in the following year. Provided the bonus is paid within 179 days of the end of the corporation's tax year, the bonus is deductible in the year that it is accrued by the PC even though it is only paid, and taxed in the hands of the recipient, in the following year.
- PCs tend not to be used in larger professional practices. If you have ten professionals practising together, spreading the benefits of the small business tax rate among ten individuals does not produce large individual tax savings. If the ten practitioners each set up their own PC to carry on business in partnership, the tax rules require that the benefits of one small business rate be spread among all ten PCs.

With the introduction of PCs, practitioners now have the same choice of business entities to organize their practices as other Canadian business people, and each have their particular advantages and disadvantages.

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