CHOICE OF ENTITY FOR LEGAL PRACTICE IN OREGON

By: Scott Schnuck, AltusLaw LLC

The author wishes to acknowledge the contributions of David Culpepper who wrote previous versions of these materials and Lindsey Latimer who assisted in this update.

I. Introduction

The choice of entity for a law firm depends on a number of factors, with no necessarily "right" answer. Key variables include: control/management of the firm; how the economic consequences are shared between the owners; and the tax treatment the attorney(s) seek. Additionally, the limitation for business liabilities is also a factor to be considered.

Entity types are defined by two independent criteria—(1) the state law under which the entity is formed and governed; and (2) the manner in which the business activities are taxed. The state law sets forth the relationship between the owners and the company, the manner of management and control, details of distributions, the fashion of winding up, and the liability protection. While there are similarities between the entities, there are key differences—heavily centered on limitation of liability, control, and distribution of the economic benefits. Under state law, the primary entity types for professionals are: sole proprietorships; general partnerships (ORS Chapter 67); professional corporations ("PCs") (ORS Chapters 58 and 60); limited liability partnerships ("LLPs") (ORS Chapter 67); and limited liability companies ("LLCs") (ORS Chapter 63).

The second key distinction for entity selection is the manner in which the owners and, potentially, the business are taxed. Business taxation is divided into two broad categories—entity-level versus pass-through taxation. With some distinctions, PCs and LLCs can elect either form of taxation. Conversely, partnerships (general or limited liability) and sole proprietorships can only have pass-through taxation. Again, neither taxation scheme is necessarily better than the other—just more or less appropriate to a situation and the owner(s)' needs.

Also, at the outset, please note that the following discussion is not intended to be particularized advice but rather general information about entities, associated taxation, and common scenarios to help inform attorneys as to potential factors that might influence their entity choice decisions.

II. State-Law Considerations

a. *Limitation of Liability*

In the modern era, any discussion of entity choice begins with the concept of limiting an owner's liability for the entity's obligations. This beginning point is true for law firms just as it is for any other business. As with all businesses, the default entity types[1]—sole proprietorships and general partnerships—do not provide any shield to the owners from the debts or obligations of the business. Under these business forms, the business is seen as an extension of the individual owner(s). As a consequence, all the liabilities of the business are the liabilities of the owner(s). Even in the general partnership case, the liability of the general partners is joint and

[1] These entity types do not require registration and can potentially arise inadvertently. Thus, if no affirmative steps are taken to select some other entity type, a solo practitioner will become a sole proprietorship, and two or more attorneys practicing together will have formed a general partnership.

several as to the outside creditor/claimant notwithstanding a potential right of contribution or indemnification as between the partners themselves. Simply put, avoidance of liability provides a strong argument to elect a liability-limiting entity for a law firm.

Conversely, PCs, LLPs, and LLCs provide a limitation of liability. With a notable exception (discussed next), the debts and obligations of these entity types belong to the entity and do not transfer to the owners of the business. Absent under-capitalization or some defect in the preservation of the distinctness of the entity, the limited-liability entities insulate their owners from the perils of the business.[2]

The general limited-liability rule, however, has a significant exception for lawyers (and other professionals) related to professional errors and omissions. An attorney has unlimited liability for his or her professional negligence of themselves and those under their direct supervision and control. *See* ORS 58.185(3)[3] (applied to LLPs under ORS 67.046(3)(c) and LLCs under ORS 63.074(2)). Additionally, a lawyer is jointly and severally liable with all the other attorneys of the firm, but only for professional errors and omissions occurring in Oregon up to an annual statutory limit. *See* ORS 58.185(4-5), ORS 58.187.[4] Like other limited-liability entities, however, only the company is liable for its obligations outside those specifically set forth in ORS 58.185—e.g., non-malpractice negligence, contractual, etc.—provided the company has taken prudent steps to meet its reasonably anticipated obligations (e.g., obtained general liability insurance for non-malpractice tort liability and maintained sufficient cash and credit reserves to pay its bills when they come due).

To better contextualize these statutory distinctions, the following chart provides an overview of how Oregon law allocates liability among firm owners, supervising attorneys, and entities themselves in common malpractice scenarios. It is intended to clarify how an attorney's supervisory role might affect the scope of liability exposure.

[2] Take note, failing to make timely distributions of profits from a limited liability entity defeats some of the advantage of the liability limitation, at least to the extent of the undistributed profits. That is, money left in the firm general account is an asset of the firm and is not shielded from creditors of the firm. Once the sums are distributed to its owners, the money becomes an asset of the owner or owners (subject to clawback and preferential transfers—the discussion of which is beyond the scope of this paper) and are now shielded.

[3] Providing "In the rendering of specified professional services on behalf of a domestic professional corporation to a person receiving the service or services, a shareholder of the corporation is personally liable as if the shareholder were rendering the service or services as an individual, only for negligent or wrongful acts or omissions or misconduct committed by the shareholder, or by a person under the direct supervision and control of the shareholder."

[4] The limitation rules and application of the joint and several liability for professional negligence can become complicated, and a full discussion is beyond the scope of this paper. The author suggests speaking with a PLF representative to discuss this in more detail as it applies to your individual circumstances.

	Scenario	Law firm	Lawyer A	Lawyer B (new admittee working under A's supervision)	Co-owner Lawyer C (assume 2 owners)
Non-professional services liability	Law firm refuses to pay for its copiers (that keep breaking)	Liable for the obligations of the entity (*see e.g., ORS 60.077;* ORS 58.158(10))	No personal liability! (*see e.g*., ORS 60.151(2); ORS 58.185(11)).	No personal liability! It is not her company!!	No personal liability! (*see e.g*., ORS 60.151(2); ORS 58.185(11)).
Professional negligence, - Lawyer A owner act/omission	Lawyer A files a complaint after the statute of limitations expires	Vicariously liable for the acts of its agents/employees acting within the scope of their agency/employment	Personally liable under ORS 58.185(3)	No personal liability because not an "owner" of the firm; not a joint tortfeasor.	Jointly and severally personally liable with Atty A under ORS 58.185(4) up to $300,000 per year as a co-owner per ORS 58.185(5).
Professional negligence, - Lawyer B act/omission; supervisory liability	Lawyer B files a complaint after the statute of limitations expires, Lawyer A was on vacation	Vicariously liable for the acts of its agents/employees acting within the scope of their agency/employment	Personally liable under ORS 58.185(3) for the acts of supervisee lawyer	Personally liable for own professional negligence regardless whether or not an owner.	Jointly and severally personally liable with Atty A (who it individually liable for A's supervisee) under ORS 58.185(4) up to $300,000 per year as a co-owner per ORS 58.185(5).

Assumes all are Oregon citizens and all actions occurred in Oregon and for Oregon clients

As a practical note, an analysis of the vicarious liability limits set forth in ORS 58.185(5), while certainly relevant, is somewhat of a red herring. Any vicarious liability, whether capped or not, is likely more than most law firm co-owners might tolerate. Therefore, a prudent lawyer in a multi-owner law firm will want to assess what level of excess coverage to obtain to avoid the impact of Subsection (4) or be practically concerned with the limits set forth in Subsection (5).

A further word on limiting liability, it is worth noting that having multiple tiers of limited-liability entities might limit some vicarious liability arising by virtue of ORS 58.185. A common multi-tier professional organization would consist of attorneys who are single shareholder PCs that are, in turn, the co-owners of a PC, LLP, or LLC. The attorneys will still remain liable for their own professional negligence (and that of their supervisees). Under a strict reading of ORS 58.185, however, an argument can be made that the vicarious liability for the acts or omissions of the other attorneys (not those directly supervised) is cut off because either the other “owners” (the other PCs) of the larger entity are not licensed professionals (focusing on the umbrella entity) or there are no other owners of the single-shareholder PCs that are “owners” of the larger entity (focusing on the lower-tier entity itself). Deciding whether to further insulate against joint and several liability through the use of multi-tier entities is a cost-risk analysis depending on the quantum of anticipated risk, the cost of insuring against that joint risk, the potential tax implications of a multi-tiered entity structure, and the administrative costs of maintaining the multiple levels of entities.

b. Limited Liability Entity Choices

As noted above, for attorneys there are three common entity types that afford limited liability protection for its owners (excepting professional liability). While the jargon for each entity type differs, all three entity types have underlying similarities: each have owners (shareholders, partners, or members); are brought into existence by a writing filed with the Oregon Secretary of State (articles of incorporation, an application for registration, or articles of organization); must be renewed annually to maintain the entity existence; and generally have an agreement

between the owners that sets forth their "deal" (bylaws and buy-sell agreement, partnership agreement, or operating agreement). No one entity type is better or worse than the other. Rather, one might be more appropriate to the attorney or attorneys' needs.

i. PC

Professional corporations are owned by shareholders. The shareholders, in turn, elect a board of directors that exercise "all corporate powers" of the company. ORS 60.301(2). This day-to-day control of the business includes the authority to bind the company to third-parties (i.e., enter into contracts) and the sale of assets and incurring of debt, neither of which require shareholder approval. *See* ORS 60.531. The corporate powers may be delegated to firm executives such as a CEO or President and other officers. But, absent limitations that might be written into the articles of incorporation or the bylaws, it is only the board of directors that have the ultimate say in running the firm. Thus, shareholders who are not directors are not generally involved in the running of the business despite the fact that they have an ownership interest in the firm.

Additionally, not only are the day-to-day decisions made under the authority of the board, so too are some out-of-the-ordinary-course decisions (subject to limitations in the firm's governing documents). For example, a firm's bylaws may be amended by the board. ORS 60.461. Distributions are determined by the board not the shareholders at large. ORS 60.181(1). Issuance of additional shares of stock of the firm is a decision reserved for the board. ORS 60.147.

A PC can be a good choice if the attorneys wish to have concentration of decision making by less than all the owners. This could be appropriate if there is a more pronounced dichotomy between "senior" and "junior" attorneys or those who do not have any interest in the "management" of the firm.

ii. LLP

Limited liability partnerships are owned by their partners. In stark contrast to the corporate model, a partnership is run by all the partners with each having a right to participate in management of the firm and needing to be present to have a quorum to make key decisions. Additionally, "each partner is an agent of the partnership for the purpose of its business." ORS 67.090(1). Finally, all partners have a right to participate in determining distributions. ORS 67.615.

In contrast to PCs, LLPs are appropriate when there is general equality among the firm owners. Also, as a practical matter, LLPs tend to be better suited for smaller firms given that making decisions in a partnership can become more cumbersome the more partners there are.

iii. LLC

A limited liability company is best described as a hybrid between a corporation and partnership. An LLC is owned by "members" and is "organized" rather than incorporated. Unlike its corporate and partnership analogs, an LLC can be either manager-managed (which looks very similar to the corporate "board" management model) or member-managed (which closely resembles the partnership model). *See* ORS 63.130.

In a manager-managed LLC, the members appoint “managers” who exercise overall management of the business. *See* ORS 63.130(2). There may be one or more managers for the LLC. Importantly, not all members need be managers. Alternatively, in a member-managed LLC, all members participate in management just as partners participate in partnerships. *See* ORS 63.130(1).

Limited liability companies are an extremely flexible entity choice and are suitable for concentrated control situations and for joint-management scenarios.

III. Tax Considerations

Control and liability limitation do not, generally, answer the whole “choice of entity” question. While any of the three primary entity types might be serviceable, how the entities are taxed can make a large difference on how appropriate the entity might be.

Some of the confusion surrounding choice of entity questions arise with the terms “c-corp” or “s-corp.” These terms are designations of tax treatment NOT state law entity type. A “c-corporation” is an entity that is taxed subject to subchapter “C” of the Internal Revenue Code. Similarly, a so-called “s-corporation” is the common parlance for an entity taxed pursuant to subchapter “S” of the Code. More confusing still, both state law “corporations” and LLCs can elect to be taxed under either subchapter C or S.

As noted above, there are two ways business activities are taxed—at the entity level or as a pass-through to its owners.

a. Entity-Level Taxation

Owners of either a PC or an LLC can elect to have their business activities taxed at an entity level—i.e., taxed under subchapter “C” or as a “c-corp.” In this case, the entity collects revenue, pays expenses, and pay taxes on the profits. Any money that is left over after taxes can either be retained within the company (without any tax effect to the individual owners) or distributed as a dividend (which is then taxed at the individual level—the infamous “double tax”).

Entity-level taxation can result in greater tax liability because of the double tax. At the most simplistic (and for the purposes of illustration only because a myriad other factors assuredly apply), the double tax arises as follows: firm income is taxed at the current federal corporate tax of 21% and any corporate dividends are taxed at the capital gains rate of 15%. To the owners, therefore, the total tax burden to the shareholder is 36%.[5] If the shareholder’s marginal tax rate is higher than this rate, then paying the double tax can save money. It is worth noting, however, that the current corporate tax rate is at a near-historic low, suggesting that this rate is almost certain to increase at some point. The double tax can be avoided, however, by ensuring all “profits” are paid to the shareholders as bonuses (which are an expense). However, bonusing the profits makes these sums subject to the employment taxes (e.g., FICA) which dividends are not.

Notwithstanding the double tax, there are advantages to electing entity-level taxation. Health benefits and long-term disability premiums are deductible business expenses. Certain

---

[5] It must be noted that the application of taxes is extremely dependent on the individual owner’s own financial situation. The illustrations provided in this paper are not intended to replace specific analysis of one’s own situation.

retirement plans are only available to "c-corporations." These other benefits—especially health insurance—can pose substantial financial incentives to elect entity-level taxation.

b. Pass-Through Taxation

Exactly opposite to entity-level taxation is the concept of "pass-through" taxation. For pass-through taxation, the entity itself does not pay income taxes. Rather, all the economic consequences of the business flow through to the owners and must, at the end of each fiscal year, land on the individual owner's tax returns.

The proportionate effect of the pass-through economics depends on the "deal" between the owners. The owners may choose to share-and-share alike participating in the distribution in proportion to their ownership interest. Conversely, the owners might wish to create incentives for production or origination or supervision or any number of other factors that weigh how the distributions are divided.

Regardless of the basis of the allocation, whether or not the cash from the firm's operations actually passes to the owners, the economic effect must be reflected on the owner's tax returns. This occurs most commonly when the firm holds cash in its firm account at year end. Unlike the entity-level taxation model where this "retained" earning has no effect on the owners, with the pass-through model the owners are taxed for this part of the profits even if they do not get the cash!

A further aspect of pure pass-through taxation is that neither partners nor members can be classified as employees of their own firm. Instead of earning wages, these owners get their share of everything that is left over after all other non-owner compensation and other expenses are paid. The owners (partners and members) can take periodic draws against their anticipated year-end distribution. But, all owner draws are subject to the self-employment taxes (the rough equivalent to the employer and employee sides of the employment taxes paid for W-2 wages).

c. Subchapter "S"

Subchapter "S" taxation can be attractive to attorneys as a way to minimize their exposure to the employment taxes. Under an S-election, owners (members or shareholders) may be employees of the company. The attorney-owner is paid a "reasonable" wage,[6] which is subject to both employer- and employee-side employment taxes and is an expense to the firm. After all business expenses are deducted (including the owner's wages), any profits of the firm can be distributed as a dividend that is not subject to the employment taxes.

Subchapter "S" taxation is not without its limitations and downsides. Unlike the distributions under pure pass-through taxation (for which there is great flexibility), all dividends must be made in strict proportion to ownership. There can be no differential payment of dividends. Therefore, any unequal payment of the firm's profits must be made through bonuses or wages—both of which are subject to the employment taxes.

---

[6] The IRS has not given express guidance on what constitutes "reasonable compensation" for an owner under an S-election. However, the IRS guidance on the reasonableness of pay in general is "the amount that a similar business would pay for the same or similar services." This is a decent rule of thumb to use in setting owner-employee wages.

Subchapter "S" of the Code is only available to state-law corporations and LLCs. The S-election is the manner in which a state-law corporation may elect a pass-through taxation model to avoid the double tax of subchapter "C."

An S-election does not have to be chosen immediately on formation. A newly formed LLC can make the election at some later point. If not made at formation, the s-election can be made effective for a fiscal year by making the election before March 15.[7] In this manner, choosing an LLC has the flexibility of being able to wait and see if making an S-election will be fruitful. A PC, however, must make the s-election at the outset if it does not wish to have entity-level taxation. As such, a PC does not afford quite the same flexibility as an LLC in this regard.

IV. Summary

a. Key Points

To summarize, key entity choice factors:

Control: centralized control favors PCs or manager-managed LLCs. It is worth noting that the composition of the board or the appointed managers can change over time consistent with evolution of the firm and owner-attorneys. Distributed control favors member-managed LLCs and LLPs.

Allocation of Revenue: highly variable allocations favor pure pass-through entities such as LLCs and LLPs. Even division of firm profits works in any entity type but also works well with PCs and LLCs making an S-election.

Minimizing Employment Taxes: making an S-election (for either a PC or an LLC) allows the owner-attorney to be a W-2 employee, but limits the allocation of the dividends in strict proportion to the ownership percentages.

b. Illustrative Example

The following example might help to illustrate how the above factors interrelate.

In this situation, a single senior attorney with a "comfortable" book has left practice at a "large" firm to hang her own shingle. She wishes to join with two new attorneys who are in the process of building their practices. Additionally, of the two newer attorneys, one desires to aggressively grow her practice but with little interest in the management of the practice, while the other is content to put in a solid day's work but who wishes to leave the "rainmaking" to others. The scenario assumes, further, that all three attorneys practice in roughly the same area and that the newer attorneys will work, at least in part, on the senior attorney's matters. Finally, the attorneys agree that their initial ownership percentages will be: senior attorney - 60%; each junior attorney - 20%.

This situation presents an unequal footing between the prospective co-venturers—in terms of legal experience, business experience, and likely current and future income expectations. In this case, the attorneys might find a more centralized control and decision-making form suitable. Therefore, an LLP is likely not the best choice, leaving either a PC or an LLC as more appropriate possibilities.

---

[7] However, it has become the practice of the IRS to allow late elections to be effective past this date.

Next, the attorneys believe it best to divide the profits or losses of the firm in a variable fashion. While they agree that differences in their "salaries" will reflect some of the difference in experience and value generation, they also want to allocate the profits of the firm in a way that rewards the creation of the income. The attorneys recognize that there is some tension between the bases to decide the allocation—the source of the work (i.e., relationship with the client), the origination of the actual matter, or the production that yielded the income can all be factors that are used. Given the variable nature of the practice of law, it is likely that a year-to-year allocation will vary, so the attorneys wish to avoid an allocation that is strictly tied to their ownership interests. Therefore, between the LLC and PC, the LLC form allows the use of a pure pass-through model where the allocations can vary annually. Additionally, the attorneys can reserve for later the decision whether to elect to make an S-election to minimize the employment taxes should that prove to be a prudent decision after they see the actual results of the firm.

In this example, then, the attorneys choose to form a manager-managed LLC, file articles of organization appointing the senior attorney as the sole manager for the time being (to be reviewed annually), and enter into an operating agreement that includes the bases to allocate the profits and losses of the firm according to their selected economic factors.

IMPORTANT NOTICES

This material is provided for informational purposes only and does not establish, report, or create the standard of care for attorneys in Oregon, nor does it represent a complete analysis of the topics presented. Readers should conduct their own appropriate legal research. The information presented does not represent legal advice. This information may not be republished, sold, or used in any other form without the written consent of the Oregon State Bar Professional Liability Fund except that permission is granted for Oregon lawyers to use and modify these materials for use in their own practices. © 2025 OSB Professional Liability Fund