

Law for Medical Students and Physicians:  
Business and Taxes  
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I. Learning Goals

At the end of the learning session the student shall:

- 1) Know the best form for most small medical practices
- 2) Have a crude idea about the principles of income taxation
- 3) Recognize the names of some business forms

II. Pre-lecture Questions

- 1) Money which you spend to make money is, in general, deductible.
- 2) The alternative minimum tax only applies to the super rich and does not affect us poor little doctors.
- 3) The income tax was invented to tax the super rich for a few years to pay for a war.
- 4) In general the owners of a corporation are not liable for the debts of the corporation.
- 5) A limited liability company has the same liability-proof structure as a corporation.
- 6) "Check the Box" is a hockey play.
- 7) When starting a business, the first question is, "Why not an LLC?"
- 8) Partnership law is more developed than LLC law.

III. The history of income taxation

The income tax was only possible because an amendment to the US Constitution (the 16<sup>th</sup>) made it legal. The amendment was to help pay for World War One, which the US, as allied to Britain in business and other ways, felt it had to enter, but could not readily afford to enter. The amendment passed because people were convinced that it would not apply to them. It was proposed as a temporary measure (to pay for the war) and only to tax the wealthiest one percent of people. The tax rate was originally to be about 1 %.

The rest, as you know, is history. The income tax affects everybody now, and is unlikely ever to go away. Money, as you know, is highly addictive.

The highest income tax rates on individuals were during the Vietnam War, when the top marginal rate was 70% plus surtax (tax on a tax) of 10%, for a net rate of 77%.

The term "marginal rate" comes from the progressive nature of the income tax. A progressive tax is not a really modern or liberal tax; it means that, the more you make, the higher your tax rate on the additional dollars. An example would be that currently, if you make \$7,200, your tax is 720 dollars (10%) but if you make \$100,000, it is different:

- 10% on the first 7300 = 730;
  - 15% on the amount from 7300 to 29,700 = 3,375;
  - 25% on the amount from 29,700 to 71,950 = 10,560;
  - 28% on the amount from 71,950 to 100,000 = 7854;
- for a total of \$22,519.

You can see that the **effective tax rate** is 22.52% and the **marginal tax rate** is 28%. The highest individual tax rate is currently 35%

#### IV. The basic principles of income taxation

In the example above, the 100,000 is not the total money that you made. It is the Taxable Income which is the total money that you made, minus exemptions, and deductions that you take.

What are tax exemptions?

Because slavery is illegal, the government cannot make you do things, it can only stop you from doing bad things (like crimes) and bribe you to do things which it wants you to do. The bribes are called tax exemptions (or tax credits). There is an exemption just for being you – the individual exemption. You can also take an exemption for having children. There are some special exemptions as well, for farmers, and for using gasohol, and odd things like that.

What are deductions?

After you remove exemptions from the total income, you have the Gross Income. The Gross income is the figure from which you remove deductions. Once the deductions are removed, the new figure is the Adjusted Gross Income, which is the next step to the taxable income.

Even though the government is taking your money, because of the constitution, they have to be fair, and deductions are a way of being fair. The deductions are:

- 1) Business expenses
- 2) Moving expenses from one job to another
- 3) Certain losses
- 4) Casualty losses
- 5) Charitable contributions
- 6) Alimony
- 7) Contributions to IRA's and certain pensions
- 8) Student loan interest
- 9) Hybrid vehicle placed in service 2005 or later
- 10) About a million odd little things too numerous to know
- 11) Certain medical expenses
- 12) Depreciation
- 13) Other taxes paid

Then you compute your tax, and remove from your tax the credits, which are special little gifts that you remove directly from your tax bill (not from AGI). Beware, however, because the state may not give a similar credit.

## V. The Alternative minimum tax

The alternative minimum tax is an attempt to maintain tax equity. Some very high income corporate and non-corporate taxpayers escaped any federal tax liability because of certain deductions. The AMT was imposed so they would have to at least pay some tax. The problem is that, as inflation has progressed, more and more middle and upper-middle income taxpayers are subject to the AMT and so a great hue and cry has arisen.

The alternative minimum tax is calculated by determining the alternative minimum taxable income (AMTI), and from that subtracting the AMTI exemption amount.

To calculate AMTI, one adds certain Tax Preference Items to the regular taxable income. The TPI's are:

- 1) Accelerated depreciation minus straight line depreciation
- 2) Tax exempt interest income
- 3) 3.5% of the gross income realized by the sale or exchange of the stock in a small business.
- 4) Other weird depreciation expenses.

The AMT rate is 26-28%.

Capital gains are the profit you make on an investment property if you have owned it for at least one year. The rate of taxation on capital gains is lower, to encourage capital formation and savings.

Recently, stock dividend income was given a favored tax status, because the income that pays dividends is taxed once to the corporation then again to the stockholder.

## VI. Business forms: the Three Traditional Forms

There are three basic business forms in traditional business law: sole proprietorship, partnership, and corporation. The laws of the fifty states have now added a very important fourth basic form, the limited liability company (see section VII).

**Sole proprietorship:** This is the "lemonade stand" model from the slides: just a person doing business. For tax purposes this is just like personal income, but it is tabulated on a form, schedule 1040 C, such that more business expenses can be deducted. Being personal taxable income, it is subject to AMT.

The owner of a sole proprietorship is liable for the debts of the business. The sole proprietor may do business under a "DBA" or assumed name, but this does not change the form or the liabilities or tax consequences.

**Partnership:** This is at least two people doing business and making it clear to the world that they are partners. The partners are liable for the debts of the business, and the partners are liable (usually) for the negligent acts of the other partners. Taxation is too complicated to discuss. The partnership automatically dissolves if one or more of the partners leaves, dies, or is disabled.

**Corporation:** This is a “made-up” person. The law permits a person (even just one) to make a corporation, which then do business but which must have certain meetings on a regular basis and do its business in such a way that it is clear that the business is being done by and for the corporation, not for the managers or owners.

Owners are not liable for the debts or the negligence of a corporation, with one exception. Managers and boards of director are not liable for the debts or negligence but may be liable for criminal acts done in the corporation’s name.

The owners of a corporation are the stockholders. People put up money, and give it to the managers to manage (do business) and hope for a return both in the increased value of the corporation (and therefore, indirectly in the shares) and because they hope to get dividends, or part of the profits of the corporation.

The owners can buy and sell shares of large corporations, making the shares useful investment tools. The owners are liable only for the value of their investment. They cannot be held liable for the wrongdoing of the managers, debts of the corporation, or money payable because of negligent acts of the corporation.

The exception to the non-liability rule of corporations is that professional corporations (special corporations for practicing medicine, law, accounting, or another profession) must pass through liability for professional malpractice to the professional.

If the owner of a corporation mixes up his personal business with that of the corporation, using the corporation as an extension of himself and his personal finances, the corporation may be deemed a fiction, and the owner may be held liable for the debts of the corporation. This is called “piercing the corporate veil”.

## VII. Why not an LLC?

The LLC was invented in Europe in the early 1970’s as a convenient form for certain risky or new business ventures. It was adopted first in the United States in Wyoming in 1977 for certain coal and cattle operations.

The LLC concept caught on like wildfire, and now all fifty states, the District of Columbia, and all Territories have legalized this business form. IN Ohio the LLC is governed by a statute (ORC 1705) enacted in 1994.

It is pretty easy and cheap to start an LLC – the simplest one would have a set of Articles of Organization, some of which are filed with the state in Columbus; and a members’ operating agreement; an address; and at least one member.

No member of an LLC may be a non-US citizen in many states.

The LLC involves minimal formalities, and provides its owners with liability from the debts of the company (except that professional malpractice liability must flow through to the professional involved).

The members may elect to be taxed either as a corporation, or an individual. Now that maximum marginal tax rates for individuals are 28% (because of AMT) at the level of 130,000 or more of income, and corporate rates cap at 38% but the effective rate caps at about 33%, there is little reason to choose corporate taxation.

Therefore, the LLC is like a sole proprietorship but with limited liability.

The only problem with the LLC format is that there is not the rich case law as there is for corporations and partnerships, so if something goes very wrong, it is not so easy to know whether the form will work as planned.

## VIII. Conclusion

**Taxes:** When you are looking at a gross income figure of over 100,000, you are always looking at about 30% off the top after deductions, for federal, state, and local taxes. That is the amount of money you will have, and adjust your spending accordingly.

**Business Form:** Think LLC. Write "LLC" on every piece of paper coming out of your business.

## IX. Post-lecture Questions

- 1) The LLC is the best form of business for most small to medium sized medical practices.
- 2) The LLC was invented in Europe and first approved for use in the United States in Wyoming in 1977.
- 3) If you earn it, they will come (and tax it).
- 4) Alternative minimum tax at 26-28% and with fewer deductions is coming to affect the middle class.
- 5) As wars increase, taxes usually increase.
- 6) The baseline value of the stock market, as measured by the DJIA, has outperformed inflation for 86 years.
- 7) Your savings gains are not taxed until you sell the asset.

## X. Bibliography

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- 5) New York State Bar Association *Preparing and Drafting Organizational Documents for New York Closely Held Limited Liability Companies and Corporations* New York State Bar Association, Albany, 2004.