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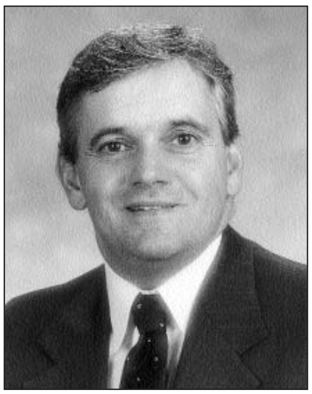
ONEONONE

A publication of the General Practice, Solo & Small Firm Section of the New York State Bar Association

A Message from the Chair

Reaching Out for Help



In light of the tragic events of September 11th, it is, of course, difficult for all of us to focus on our day-to-day responsibilities and to put them in perspective. Over 1,300 lawyers, many of whom are our members, had offices in the World Trade Center. The NYSBA is trying to determine their fate as well as the fate of all other members of the Association who had offices at the WTC. Our hearts go out to all the victims and their families.

So, what can we do to help? As lawyers, we need to determine what is the best way for us to lend our skills to those in need. The rescue and recovery workers are using their skills as fire fighters, police officers, medical professionals and iron workers to assist at what has become known as "Ground Zero." Where does the training and experience of an attorney fit in?

Over the next couple of weeks the General Practice, Solo & Small Firm Section will be deciding what course of action we can take that will be meaningful. Any suggestions from any of our members would be welcome. Maybe there is an idea out there about how to help the victims' families in some way or another as they struggle with going on with the rest of their lives.

Our Section has over 3,000 members, very few of whom have ever been shy about sharing their thoughts with other attorneys. If you have any thoughts or ideas about how we as a group can help, please let us know. Send them to us by fax or by e-mail. We can then quickly put some of these thoughts into action and convey the proposal to all of our Section's members to whom we will be looking for participation.

Send your ideas to me at jfetter@scolaro.com or by fax at 315-425-3656. You can also send your ideas directly to Steve Gallagher at the Bar Center at sgallagher@nysba.org or to Steve by fax at 518-487-5694.

Everyone wants to help. The difficulty is knowing how to help.

Jeffrey M. Fetter

September 19, 2001

Inside

NYSBA 125 Years

From the Editor

The legal profession's response to the recent terrorist attack on our country has been commendable. Attorneys throughout the state have donated funds, resources and have volunteered to participate in pro bono activities to aid the victims and their families after this tragic event. These events demonstrate, once again, the vital role lawyers play in this free society and in the safeguarding of our nation's well-being.

In order to continue to play a vital role in the service of our nation, we must be ready to respond to the ever-changing face of the legal marketplace. It is imperative that we, as professionals, continue to strive to embrace new technology, new information and to participate in the development of just and fair laws so that we may better serve the citizens of this state and this country.

This issue of *One on One* provides some valuable information for solo, small firms and general practitioners as we continue to "re-tool" and attempt to meet the ever-changing demands of the marketplace.

In that regard, subscribers will be interested to read about newly enacted rules involving multi-disciplinary practice (MDP), as well as changes in the tax code. Practitioners will also be interested in practical information regarding the avoidance of grievance complaints, as well as choosing the proper business entity when starting a legal practice. This issue also provides some substantive information regarding the interface of family law and the state law for family practitioners.

Finally, beginning with this issue, a new column will be devoted to Law Office Economics and Management (LOEM). The information contained in this column has been provided by Stephen Gallagher, Director of the LOEM Department at the New York State Bar Association. The Section is grateful for his contribution.

It is my hope that *One on One* will continue to be a resource for cutting-edge information regarding technology and LOEM. There is no question that the profession will continue to embrace these resources in order to adequately serve the new and ever-changing marketplace.

Frank G. D'Angelo

Request for Articles

If you have written an article and would like to have it published in
One on One
please submit to any of the Co-Editors:

Frank G. D'Angelo
999 Franklin Avenue,
Suite 100
Garden City, NY 11530

Martin Minkowitz
180 Maiden Lane
New York, NY 10038

Charles B. Rosenstein
7 Airport Park Boulevard
Latham, NY 12110

Articles should be submitted on a 3 1/2" floppy disk, in WordPerfect or Microsoft Word, together with a printed original and biographical information.

Organization of the Professional Practice—Entity Structuring—Tax and Non-Tax Planning: Sole Proprietor, Partnership, PLLC, LLP, S Corporation, C Corporation

By Richard E. Scrimale

I. Introduction

Today's economy provides the professional numerous options in which to conduct business. The "old-school" sole proprietorships and general partnerships were initially replaced by the professional corporation as well as partnerships of professional corporations. However, in 1994 with the passage of the Limited Liability Company Act as well as the Amendment to the Partnership Law, Professional Limited Liability Company and Registered Limited Liability Partnerships became alternatives to sole proprietorships, general partnerships and professional corporations. This article discusses the characteristics and benefits of each of the entities as well as a separate discussion of the tax considerations for each type of entity.

II. Non-Tax Considerations

A. Sole Proprietorships

A sole proprietorship is an individual conducting business under an assumed name with the intent of making a profit. A sole proprietorship is created by filing a Certificate of Assumed Name with each County Clerk in which the sole proprietorship is going to conduct business. The sole proprietor has complete control and manages the business on a daily basis, unless he/she hires employees to conduct such activities on his/her behalf. No person has the ability to act for or bind the sole proprietorship without the consent of the owner.

1. Advantages and Disadvantages of a Sole Proprietorship

The main advantage of a sole proprietorship is the ease of formation as well as the low cost of formation. In addition, the sole proprietor reports all of his income on his personal return so there is no added cost of an additional tax return to be prepared.

The most significant disadvantage of a sole proprietorship is the unlimited personal liability of the owner. All of the owner's non-business assets are at risk and available to the creditors of the business. In addition, the sole proprietorship may be limited in its ability to raise capital or grow at a significant pace because of the limitations of a single owner.

B. General Partnerships

A general partnership is two or more persons operating a business under an assumed name for the purpose of making a profit.

1. Formation and Operations of a General Partnership

A general partnership is created by filing a Business Certificate for Partners with each County Clerk in which the general partnership is going to conduct business. A written partnership agreement, while not required by law, usually governs the management of the partnership which may include provisions for a managing partner, managing committee, super-majority provisions for extraordinary acts, distributions, etc. Usually, each partner has the authority to act for and bind the partnership. The relationship between the partnership and each of its partners is a principal-agent relationship.

2. Advantages and Disadvantages of a General Partnership

The main advantage of a general partnership is the ease of formation as well as the low cost of formation. As discussed below, the tax status of a partnership is the most flexible alternative, especially in light of the special allocations that are common in professional practices.

The most significant disadvantage of the general partnership is the unlimited, joint and several personal liability of the partners, including the malpractice of his/her co-partners. All of the partners' non-business assets are at risk and available to the creditors of the partnership.

C. Professional Limited Liability Companies

A professional limited liability company is a separate legal entity created under state law to conduct business in the profession for which it is authorized. The formation, existence and operations of a Professional Limited Liability Company are governed by the N.Y. Limited Liability Company Law (LLCL). Article 12 of the LLCL provides for the formation of businesses which conduct professional practices, such as attorneys, physicians, accountants, engineers, etc.[1] It should be noted that a professional limited liability company shall not engage in any business other than the rendering of the professional services for which it is formed, except for certain investments in real estate, stocks or other types of investments.[2]

1. Formation and Operations of a Professional Limited Liability Company

In order to form a professional limited liability company, the Articles of Organization must be prepared. Prior to filing the Articles of Organization, consent from the appropriate professional licensing department must be obtained and submitted with the Articles of Organization to the Secretary of State. LLCL 203(e) sets forth the required contents of the Articles of Organization, which must include:

1. the name of the limited liability company;
2. the purposes for which the limited liability company is formed (which must explicitly state the profession to be practiced by the limited liability company);
3. the county within the state in which the office of the limited liability company is located;
4. a designation of the Secretary of State as agent of the limited liability company upon whom process against it may be served;
5. the post office address within or without the state to which the Secretary of State shall mail a copy of any process; and
6. if the limited liability company has a registered agent, the name and address of such registered agent.[3]

The name of the limited liability company may contain the names of the professionals conducting such profession and must include an indicator such as "Professional Limited Liability Company" or "PLLC."[4] A professional limited liability company may not render professional services except through individuals authorized or licensed to render such professional service.[5]

Each limited liability company is required to adopt a written operating agreement.[6] The operating agreement, in conjunction with the LLCL, govern the operations of the limited liability company. In the event the operating agreement and the LLCL shall conflict, the provisions of the LLCL shall control. The LLCL shall govern the operations of a professional limited liability company except to the extent Article 12 of the LLCL shall conflict with the LLCL generally, in which case Article 12 of LLCL shall control.[7]

In the event of the death or legal disqualification of a member to conduct the profession of the professional limited liability company, the shares of such shareholder shall be redeemed within six months of such event at book value of such shares.[8] However, the operating agreement may shorten the period of redemption or may modify the purchase price.

A PLLC is governed pursuant to the terms of the written operating agreement that was adopted by its members. Generally, the operating agreement will contain provisions regarding management, income allocations, distributions, etc. The PLLC is very flexible in that it can be managed by members or managers. In addition, a management committee of members or managers can also be utilized. The operating agreement can also include a provision electing officers, similar to a corporation. A third party may rely on the management provisions of the operating agreement in conducting business with the PLLC. The operating agreement can grant or withhold authority to transact business on behalf of the PLLC to/from its members or managers. Certain extraordinary events may require a supermajority or unanimous vote of the members or managers prior to authorizing such act.

2. Advantages and Disadvantages of a Professional Limited Liability Company

The main advantage of operating a business as a professional limited liability company is the limited liability afforded to its members. Provided the members have fully paid their capital contribution and the separate legal existence of the company has been respected, the liability of the members is limited to the amount of their capital contributions. If the members disregard the separate legal existence of the limited liability company, such as (1) co-mingling company funds with the personal funds of members or (2) misleading third parties to believe the members are conducting business in an individual capacity; a third party may "pierce the corporate veil" and subject the members to personal liability in excess of their capital contributions. An important difference between a limited liability company and a professional limited liability company is the liability of a member in a professional limited liability company. Each member, manager, employee or agent of a professional limited liability company will be *personally and fully liable* and accountable for any negligent or wrongful act or misconduct committed by him/her or by any person under his/her direct supervision and control while rendering professional services on behalf of a professional limited liability company.[9] In other words, the professional/member of a personal limited liability company retains personal liability for his/her personal acts of professional malpractice and the acts of professional malpractice by individuals which are under his/her direct supervision. On the other hand, a professional/member is not personally liable for the acts of professional malpractice of other professional/members, managers, employees or agents which are not under his/her direct supervision. A professional limited liability company can be either a single member, taxed as a sole proprietorship or a multiple member, taxed as a general partnership.

The formation of a professional limited liability company is more expensive than the formation of other entities such as a sole proprietorship or a general partnership. In addition, a professional limited liability company has a publishing requirement which increases the cost of formation, even over the cost of the formation of a professional corporation. Another disadvantage is that, on account of the requirement to obtain the consent of the appropriate professional licensing department, the length of time to form a professional limited liability company can be longer than entities other than professional corporations.

D. Registered Limited Liability Partnerships

A registered limited liability partnership is a general partnership, each of whose partners is a professional authorized by law to render professional service and registers with the Secretary of State to practice such profession.

1. Formation and Operations of a Registered Limited Liability Partnership

The formation, existence and operations of a registered limited liability partnership (LLP) are governed by Article 8-B of the N.Y. Partnership Law. Section 121-1500 of the Partnership Law provides for the formation of businesses which conduct professional practices, such as attorneys, physicians, accountants, engineers, etc.

In order to form a professional limited liability partnership, a Certificate of Registration must be prepared as well as a Business Certificate for Partners. The Business Certificate of Partners must be filed with the County Clerk within each county the partnership is going to conduct business. Unlike a professional limited liability company or a professional corporation, an LLP does not need to obtain consent from any professional licensing department prior to filing the Certificate of Registration or Business Certificate of Partners. Partenership Law § 121-1500(a) sets forth the required contents of the Certificate of Registration, which must include:

1. the name of the registered limited liability partnership;
2. the address of the principal office of the partnership;
3. the profession or professions to be practiced by such partnership;
4. a designation of the Secretary of State as agent of the limited liability partnership upon whom process against it may be served;
5. the post office address within or without the state to which the Secretary of State shall mail a copy of any process;
6. if the partnership has a registered agent, the name and address of such registered agent;
7. that the partnership is filing for status as a registered limited liability partnership; and
8. the effective date of the filing.[10]

The name of the limited liability partnership may contain the names of the professionals conducting such profession and must include an indicator such as "Registered Limited Liability Partnership," "RLLP" or "LLP."[11] A professional limited liability partnership may not render professional services except through individuals authorized or licensed to render such professional service.[12] In addition to professional services that it is authorized to practice, an LLP may conduct or transact any other business a general partnership may conduct.[13]

In the event of the death or legal disqualification of a member to conduct the profession of the professional limited liability company, the membership interest of such member shall be redeemed within six months of such event at book value of such shares.[14] However, the operating agreement may shorten the period of redemption or may modify the purchase price.

Similarly to a general partnership and PLLC, an LLP's operations are governed by the terms of the partnership, agreement (operating agreement in PLLC). A written partnership agreement, while not required by law, usually governs the management of the partnership which may include provisions for a managing partner, managing committee, super-majority provisions for extraordinary acts, distributions, etc. Usually, each partner has the authority to act for and bind the partnership. The relationship between the partnership and each of its partners is a principal-agent relationship.

Within 60 days prior to the fifth anniversary of the effective date of its registration and every five years thereafter, the LLP must furnish a statement to the Secretary of State stating the following:

1. the name of the limited liability partnership;
2. the address of the principal office of the limited liability partnership;
3. the post office address to which the Secretary of State shall mail a copy of any process accepted; and
4. a statement that the limited liability partnership is eligible to register as a registered limited liability partnership.[15]

2. Advantages and Disadvantages of a Registered Limited Liability Partnership

The main advantage of operating a business as a registered limited liability partnership is the limited liability afforded to its partners. Provided the partners have fully paid their capital contribution, the liability of the partners is limited to the amount of their capital contributions. If the partners mislead third parties to believe the partners are conducting business in an individual capacity or as a general partnership, the partners may be subject to personal liability in excess of their capital contributions. However, each partner will be *personally and fully liable* and accountable for any negligent or wrongful act or misconduct committed by him/her or by any person under his/her direct supervision and control while rendering professional services on behalf of a registered limited liability partnership.[16] A professional limited liability company is taxed as a general partnership which is the most flexible alternative, especially in light of the special allocations that are common in professional practices.

Unlike a PLLC, an LLP requires that there be at least two licensed partners in the profession in which the LLP conducts professional services at all times otherwise the LLP will dissolve. The formation of a professional limited liability partnership is more expensive than the formation of other entities such as a sole proprietorship or a general partnership and, similar to a PLLC, is also subject to the publishing requirement.

E. Professional Corporations

1. Formation and Operations of a Professional Corporation

The formation, existence and operations of a professional corporation are governed by the N.Y. Business Corporation Law (BCL). Article 15 of the BCL provides for the incorporation of businesses which conduct professional practices, such as attorneys, physicians, accountants, engineers, etc.[17] It should be noted that a professional service corporation shall not engage in any business other than the rendering of the professional services for which it is incorporated, except for certain investments in real estate, stocks or other types of investments.[18]

In order to form a professional corporation, a Certificate of Incorporation must be prepared. Prior to filing the Certificate of Incorporation, consent from the appropriate professional licensing department must be obtained and submitted with the Certificate of Incorporation to the Secretary of State. BCL § 402 sets forth the required contents of the Certificate of Incorporation. Each Certificate must include:

1. the name of the corporation;
2. the purposes for which the corporation is formed (which must explicitly state the profession to be practiced by the corporation);
3. the county within the state in which the office of the corporation is located;
4. the aggregate number of shares which the corporation has the authority to issue and the class or series of such shares;
5. a designation of the Secretary of State as agent of the corporation upon whom process against it may be served;
6. the post office address within or without the state to which the Secretary of State shall mail a copy of any process;
7. if the corporation has a registered agent, the name and address of such registered agent; and
8. the duration of the corporation if other than perpetual.[19]

The name of the corporation may contain the names of the professionals conducting such profession and must include an indicator such as "Professional Corporation" or "P.C."[20] A professional service corporation may not render professional services except through individuals authorized or licensed to render such professional service.[21]

Upon the incorporator executing the certificate of incorporation, the existence of the corporation shall commence upon filing of the Certificate of Incorporation by the Secretary of State.[22]

After the filing of the Certificate of Incorporation, BCL § 404 requires that the incorporator hold an organizational meeting for the purpose of adopting by-laws of the corporation and electing the initial members of the

Board of Directors of the corporation.[23] Thereafter, the initial members of the Board of Directors will hold its first meeting whereby the directors will take the following acts: (1) ratify the acts of the incorporator; (2) ratify the by-laws adopted by the incorporator; (3) issue shares of stock pursuant to stock subscriptions; (4) designate a banking institution; (5) elect officers; and (6) address any other matters to properly come before the meeting. Subsequent to the Board of Directors' meeting, the first meeting of the shareholders will be held.[24] At such meeting, the shareholders will take the following actions: (1) ratify the acts of the incorporator and the Board of Directors; (2) ratify the by-laws of the corporation; (3) elect members of the Board of Directors for the upcoming year; and (4) address any other matters to properly come before the meeting.

Each corporation is required to adopt a set of by-laws.[25] The by-laws, in conjunction with the BCL, govern the operations of the corporation. The by-laws will contain provisions such as the election of the Board of Directors and Officers, meetings, notice requirements, quorum requirements, proxies, voting, compensation, stock certificates, corporate seal, fiscal year, amendments and indemnification. The by-laws may be adopted, amended or repealed from time to time by the Board of Directors, unless the Certificate of Incorporation or the existing by-laws require adoption by the shareholders. In the event the by-laws of a corporation and the BCL shall conflict, the provisions of the BCL shall control. The BCL shall govern the operations of a professional service corporation except to the extent Article 15 of the BCL shall conflict with the BCL generally, in which case Article 15 of the BCL shall control.[26]

In the event of the death or legal disqualification of a shareholder to conduct the profession of the professional service corporation, the shares of such shareholder shall be redeemed within six months of such event at book value of such shares.[27] However, the Certificate of Incorporation or a Shareholders Agreement may shorten the period of redemption or may modify the purchase price.

An annual meeting of the shareholders is required to be held at least annually for the election of the Board of Directors and the transaction of any other business to properly come before the meeting.[28] Usually, the newly elected members of the Board of Directors will hold an annual meeting following the annual meeting of the shareholders in order to elect officers for the upcoming year and to discuss any other matters to properly come before the meeting.[29] Special meetings of the shareholders or Board of Directors may be called from time to time pursuant to the rules set forth in the by-laws of the corporation.[30]

In the event the corporation is going to conduct business in another jurisdiction, the corporation must apply for the authority to transact business in each such jurisdiction. Along with the privilege of transacting business in the foreign jurisdiction, the corporation is obligated to comply with the tax reporting requirements in the foreign jurisdiction. The tax treatment of the corporation can vary greatly from one state to another.

2. Advantages and Disadvantages of a Professional Corporation

The main advantage of operating a business as a corporation is the limited liability afforded to the shareholders of the corporation. Provided the stock issued to the shareholders is fully paid at the time of purchase and the separate corporate existence has been respected, the liability of the shareholders is limited to the amount of their capital contributions.

If the shareholders disregard the separate legal existence of a corporation, such as (1) co-mingling corporate funds with the personal funds of shareholders or (2) misleading third parties to believe the shareholders are conducting business in an individual capacity; a third party may "pierce the corporate veil" and subject the shareholders to personal liability in excess of their capital contributions. An important difference between a business corporation and a professional corporation is the liability of a shareholder in a professional corporation. Each shareholder, employee or agent of a professional service corporation will be *personally and fully liable* and accountable for any negligent or wrongful act or misconduct committed by him/her or by any person under his/her direct supervision and control while rendering professional services on behalf of a professional service corporation.[31] In other words, the professional/shareholder of a personal service corporation retains personal liability for his/her personal acts of professional malpractice and the acts of professional malpractice by individuals which are under his/her direct supervision. On the other hand, a professional/shareholder is not personally liable for the acts of professional malpractice of other professional/shareholders, employees or agents which are not under his/her direct supervision.

Another advantage of the corporate form of doing business is the perpetual existence of a corporation. Unlike a sole proprietorship or a partnership, the existence of a corporation does not cease upon the death of a shareholder.

The ownership interests in the corporation, to wit: the shares of stock are easily transferable from one owner to a successor owner. In the absence of a shareholders agreement which restricts the transfer of stock, the shares of stock are freely transferable without any restrictions. The management of the corporation is centralized with the Board of Directors, who are elected by the shareholders. The day-to-day operations of the corporation are managed by the officers who are appointed by the Board of Directors.

Generally, the formation of a corporation is more expensive than the formation of other entities such as a sole proprietorship or a general partnership. In addition, the operations of a corporation are much more formal than other types of entities. For example, in order to obtain bank financing for a transaction, a corporation must have such a transaction approved by its Board of Directors. The officers must be authorized by resolutions of the Board of Directors to execute the various bank documents. In the case of a sole proprietorship, these formalities are unnecessary. In addition, unless the corporation elects "S" corporation status, the corporation will be subject to a double income tax on its profits.

III. Tax Considerations

A. Sole Proprietorships

1. Income Tax

A sole proprietorship does not file a separate income tax return apart from its owner. Rather, the sole proprietor includes all of the income and expenses on his annual individual tax return on a separate schedule, to wit: Schedule C to Federal Form 1040.

2. Self-Employment Earnings Tax

An individual's net earnings from self-employment include the individual's income or loss from any trade or business carried on by such individual. The combined rate of tax for self-employment income is 15.3 percent. This rate is the aggregate of two separate taxes, social security and Medicare taxes. For the calendar year 2001, the social security tax is 12.4 percent on self-employment earnings up to $80,400 ($9,969.60 maximum tax). For the calendar year 2001, the Medicare tax is 2.9 percent on all self-employment earnings with no maximum amount.

B. General Partnerships, Professional Limited Liability Companies and Limited Liability Partnerships

1. Historical Background

Historically, an LLP and a PLLC may have been taxed differently depending upon their respective characteristics. Under the Internal Revenue Code (I.R.C.) of 1986, as amended, a general partnership does not pay income tax, rather its items of income, loss, deduction or credit pass-through to its partners. As a result of its status, an LLP was generally taxed as a partnership unless the LLP, on account of provisions of its partnership agreement, had more corporate characteristics than non-corporate characteristics. The corporate characteristics test is described below.

The I.R.C. does not explicitly provide for a method of taxation for professional limited liability companies (PLLC). The Treasury Regulations (the "Regulations") provided some guidance as to classification for tax purposes by applying a test of corporate vs. non-corporate characteristics. Prior to the effective date of the "check-the-box" regulations, there was no definitive rule in the I.R.C. or the Regulations which provided for the taxation of PLLCs. Generally, a PLLC was taxed as either a corporation or a partnership, depending on the number of corporate characteristics the PLLC contained. If the PLLC had more corporate characteristics than non-corporate characteristics, it was classified as a corporation for federal income tax purposes. Otherwise, the PLLC was classified as a partnership for federal income tax purposes.

The Regulations looked primarily to four corporate characteristics, to wit: limited liability, centralization of management, continuity of life and free transferability of interest. Each PLLC has the corporate characteristic of limited liability, therefore, in order to be classified as a partnership, the PLLC could only have one of the remaining three corporate characteristics to preserve its partnership tax status.

2. Check-the-Box Regulations—Single and Multiple Member PLLCs, Foreign PLLCs and Electing Out of the Default Rules

On December 18, 1996, the Treasury Department issued final "check-the-box" regulations to provide taxpayers with a definitive means to determine the tax method for LLP/PLLCs.[32] The check-the-box regulations provide that if the I.R.C. does not explicitly provide for the method of taxation for an entity, then the default rules under the check-the-box regulations will apply.[33] For example, a corporation is explicitly taxed under Sub-chapter C or Sub-chapter S of the I.R.C., therefore, any entity created under state law to be a corporation will not be subject to the check-the-box regulations. On the other hand, an entity such as a PLLC which does not have a specific method of taxation under the I.R.C., will be classified for tax purposes according to the check-the-box regulations.

Pursuant to the default rules under the check-the-box regulations, a single-member PLLC (i.e., a PLLC whose membership interests are entirely owned by one person), is disregarded for federal income tax purposes as an entity separate from its owner.[34] A natural person who forms a single-member PLLC will continue to be taxed as a sole proprietorship by filing a Schedule C to his/her Form 1040. A single-member PLLC which is owned by a person other than a natural person, will be disregarded and treated as a pass-through conduit, such as a branch or division of the parent company. The single-member PLLC may, at its option, elect to be treated as an association taxable as a corporation, rather than be disregarded. In such instance, the PLLC must file a Form 8832.

Pursuant to the default rules under the check-the-box regulations, a PLLC which has two or more members is classified as a partnership for federal income tax purposes.[35] Once again, the PLLC may, at its option, elect to be treated as an association taxable as a corporation, which will result in the PLLC being subject to the corporate income tax.

A foreign PLLC (or other foreign eligible entity) will be taxed (i) as a partnership if the PLLC has two or more members and at least one member does not have limited liability, (ii) as an association, taxable as a corporation, if all members (single or multiple members) have limited liability, or (iii) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.[36]

An eligible entity may elect out of the default rules by filing Federal Form 8832. The election will take effect on the date Form 8832 is filed unless a date is entered on Line 3 of Form 8832 which will be the effective date. However, the effective date cannot be more than 75 days prior to the date Form 8832 is filed or later than 12 months after the date the election is filed.[37] Once an entity makes an affirmative election to change its classification for federal income tax purposes, it may not change its classification for a period of 60 months from the effective date without the consent of the Internal Revenue Service. It should be noted that the Regulations provide that an election from the date of formation is not considered a change of classification. "An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv)."[38]

3. Partnership Classification

A partnership is a pass-through entity which means that it is not subject to federal income tax. However, a partnership must file an informational annual tax return on Federal Form 1065. On its annual tax return, the partnership will state the results from its operation as well as separately state certain required items of income, loss, deduction or credit. Attached to the partnership's tax return is a Schedule K-1 to Form 1065 for each of the partners (or members, in the case of a PLLC). The Schedule K-1 will state each partner's share of partnership income, loss, deduction or credit. The partner must include in his/her taxable income the amount of the income set forth on his/her Schedule K-1 regardless of whether or not he/she received any money or other property from the partnership in a form of distributions.

4. Partner and Partnership's Basis

The formation of a partnership will not result in the recognition of gain or loss by either the partnership or the partner. The I.R.C. § 721(a) states that "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."[39] There are some exceptions to this general rule such as: (i) the transfer of appreciated property to a partnership that would be treated as an investment company if the partnership were incorporated,[40] or (ii) the receipt of a capital interest in a partnership in exchange for the services of a partner that are to be provided to the partnership.[41] The receipt of a profits interest in a partnership in exchange for services is not taxable to the partner.[42]

The partnership takes a transferred basis in the assets in which it receives. The partnership's basis in its assets equals the basis of the assets of the partner who contributed such property to the partnership plus any gain recognized by the partner on the transfer.[43]

The basis in the partnership interest received by a contributing partner is equal to (i) the amount of money contributed to the partnership, (ii) the adjusted basis of any property contributed to the partnership, and (iii) any gain recognized by the partner.[44] However, if the partnership either assumes or takes subject to any liability related to the contributed property, the partner's basis in his partnership interest is decreased by the entire amount of the liability and simultaneously therewith increased by the partner's allocable share of the liability.

Example: A, B and C form a partnership. A and B each contribute $30,000 of cash to the partnership. C contributes a piece of property with a fair market value of $90,000 (with a basis of $80,000) which is encumbered with a $60,000 mortgage. A and B's initial basis in their partnership interest as a result of their contribution of money is $30,000. C's basis in his partnership interest is initially $80,000, however, it is reduced by $60,000 (the amount of the liability assumed by the partnership) and increased by his one-third share of the partnership debt ($60,000 x 1/3) of $20,000, resulting in a basis of $40,000. A and B's basis in their partnership interest is increased by their allocable share of the partnership debt (i.e., $60,000 x 1/3) of $20,000, resulting in a basis of $50,000.

A's Basis in ABC Partnership:

Money Contributed	$30,000
Plus: Allocable Share of Partnership Debt	+20,000
Basis in Partnership Interest	$50,000

B's Basis in ABC Partnership:

Money Contributed	$30,000
Plus: Allocable Share of Partnership Debt	+20,000
Basis in Partnership Interest	$50,000

C's Basis in ABC Partnership:

Basis in Property Contributed	$80,000
Less: Liability Assumed by Partnership	-60,000
Plus: Allocable Share of Partnership Debt	+20,000
Basis in Partnership Interest	$40,000

During the period of ownership by a partner, his/her basis in the partnership interest changes with partnership activities. Generally, the basis of a partner's partnership interest is increased by his/her capital contributions, his/her allocable share of partnership taxable income and his/her allocable share of the partnership's tax-exempt income.[45] On the other hand, a partner's basis in his/her partnership interest is decreased by distributions, whether in cash or in kind, his/her allocable share of partnership losses, and his/her allocable share of non-deductible expenditures.[46] If a distribution would result in a partner having a negative basis, the partner must recognize income to the extent such distribution would cause a negative basis and his/her remaining basis in the partnership interest would be reduced to zero.

Generally, any increase in a partner's share of partnership liabilities is treated as a contribution of money that increases such partner's basis in his/her partnership interest.[47] Conversely, a decrease in a partnership's liabilities is treated as a distribution of money by the partnership, which results in a decrease in such partner's basis in his/her partnership interest.[48] However, if the decrease in a partner's share of partnership liabilities would result in the partner having a negative basis, the partner must recognize gain to the extent of the negative amount of basis.[49]

Generally, the liabilities of a partnership are allocated to the respective partners to the extent that each partner bears the risk of nonpayment.

Recourse liabilities are allocated to the partner or partners which must make a contribution to the partnership or pay the creditor if the partnership was unable to satisfy the creditor in full.[50] For example, a general partner of a limited partnership would have his/her basis in his/her partnership interest increased by the full amount of the recourse liabilities of the limited partnership. The limited partners of the limited partnership would not have any basis adjustments for recourse liabilities because they would have no liability to the creditor (except if the limited partners agreed to indemnify the general partner who was subject to the liability or to the extent the limited partner had agreed to restore a deficit in his capital account under the terms of the limited partnership agreement).

Non-recourse liabilities are liabilities for which no partner bears the risk of nonpayment beyond his/her capital contribution to the partnership. Generally, partners in an LLP and members in a PLLC have their liability limited to their capital contribution. Therefore, absent a personal guaranty by a partner/member or specific assumption of a liability of the LLP/PLLC by a partner/member, all liabilities of the LLP/PLLC will be non-recourse liabilities for federal income tax purposes. In such instance, non-recourse liabilities are generally allocated to the partners or members in proportion to their partnership or membership interest in the partnership or PLLC.[51]

5. Allocations of Partnership Gain or Loss

The I.R.C. § 704 states that "a partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." [52] Generally, a partner's distributive share is determined in accordance with each partner's interest in the partnership.[53] Therefore, except for special allocations, a partner's share of gain, deduction or credit is based on his/her partnership interest or membership percentage.

In order for a special allocation to be respected by the Internal Revenue Service, the special allocation must meet the "substantial economic effect" test under the Regulations. "First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect must be substantial (within the meaning of paragraph (b)(2)(iii) of this section)."[54] The special allocation "must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[55]

The Regulations establish three requirements for the partnership agreement (or operating agreement, in the case of a PLLC) in order for the special allocation to have economic effect. Throughout the full term of the partnership, the partnership agreement must provide:

> (1) For the determination and maintenance of the partners' capital accounts

> in accordance with the rules of paragraph (b)(2)(iv) of this section;
>
> (2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation); and
>
> (3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to the other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).[56]

The special allocation must still be substantial in order for the special allocation to be respected by the Internal Revenue Service. "The economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."[57]

Generally, there are three tests to determine substantiality, "Shifting Allocations," "Transitory Allocations," and "Overall Tax Effects." Provided that the special allocation does not fail any of these tests, such allocation will be determined to be substantial, and coupled with the satisfaction of the economic effect test, the special allocation will be respected by the Internal Revenue Service.

> If the special allocation merely has the effect of shifting tax consequences between the partners and does not result in a substantial difference in the partners' capital accounts at the end of the taxable year, then the allocation will not be determined to be substantial. The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and (2) the total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).[58]

If the special allocation merely has the effect of shifting tax consequences between the partners during a tax year and subsequently thereto (and within five taxable years) there is an offsetting allocation that does not result in a substantial difference in the partners' capital accounts at the end of the taxable year of the offsetting allocation, then the allocation will not be determined to be substantial.

> If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and at the time the allocations become part of the partnership agreement, there is a strong likelihood that

> (1) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and the offsetting allocation(s) were not contained in the partnership agreement, and
>
> (2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership), the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. . . [I]t will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis).[59]

If the special allocation has the effect of enhancing the after-tax position of one or more partners while not impairing the after-tax economic consequences of any other partner, the allocation will be determined to not be substantial.

> The economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.[60]

6. Cash Distributions and Guaranteed Payments

Generally, cash distributions are non-taxable to the partner receiving the distribution.[61] However, the partner's basis in his/her partnership interest is reduced by the amount of the cash distribution.[62] If the amount of cash distributed to a partner exceeds his/her basis in the partnership interest, then the partner must recognize taxable income by the amount the cash distribution exceeds his/her partnership basis.[63] After the distribution, the partner's basis in his/her partnership interest will be zero.

A guaranteed payment is a fixed payment made by the partnership to a partner for either services rendered or for the use of capital.[64] The partnership takes a tax deduction as an ordinary and necessary business expense and the partner receiving the guaranteed payment receives ordinary income.[65] Guaranteed payments are determined without regard to the income of the partnership.

Generally a partner does not recognize any gain on a distribution of property until such partner sells or otherwise disposes of the distributed property.[66] In such instance, the partner's basis in his/her partnership interest is decreased by the amount of the in-kind property distribution. However, if the partnership distributed property to a partner and the partner also assumed a liability or accepted the property subject to a liability, then the partner's share of partnership liabilities would decrease. In such case, the amount of the decrease of the partner's share of partnership liabilities is a "deemed distribution" of money which could result in a gain to be recognized by the partner if the assumption of liabilities would cause a negative basis.[67]

The partner who contributes property other than cash may have to recognize gain or loss if such contributed property is distributed to a different partner within five years of the contribution (with respect to property contributed before June 9, 1997) or within seven years (for property contributed after June 8, 1997).[68] The gain or loss to be recognized by the partner is equal to the difference between the fair market value of the property at the time of contribution to the partnership and the partner's adjusted tax basis in the property at the time of contribution to the partnership. The contributing partner is allocated the pre-contribution gain or loss as if the partner had sold the property to the partnership at the time of his/her contribution. Similarly, I.R.C. § 737(b) provides that a partner contributing appreciated property to a partnership will recognize his/her pre-contribution gain on such property if he/she receives a distribution of other partnership property (except money) within a seven year period from the date of contribution.[69]

7. Sale or Liquidation of Partnership Interest

Generally, the sale or exchange of a partnership interest is treated as a sale of a capital asset rather than a sale of the various partnership assets.[70] The partner's gain or loss is calculated by determining the amount realized on the transaction, reduced by the partner's basis in his partnership interest. However, if the partnership has unrealized receivables or substantially appreciated inventory, the amount realized by the partner which is allocable to such items will result in ordinary income or loss.[71] In the event that within any 12-month period 50 percent or more of the partnership interest in the partnership is sold or exchanged, there is a termination of the partnership for federal income tax purposes.[72]

In the event a partnership redeems a partner's partnership interest by distributing property other than money or marketable securities, the partnership and partner will not recognize any gain or loss on the transaction (except as provided in Section III.B.6. above).[73] The partner will take a transferred basis in the partnership assets[74] and will recognize any gain on the subsequent sale of the assets. However, if a partner receives money or marketable securities in exchange for his partnership interest, the partner must recognize gain to the extent the cash or marketable securities exceed his basis in the partnership interest.[75] If a partner is relieved of any or all of his/her share of partnership liabilities in such transaction, the discharge from such liability is treated as a cash distribution to such partner.[76] The character of a gain which a partner must recognize on a redemption of his partnership interest is capital gain,[77] unless the amount received is allocable to the partner's share of the partnership's unrealized receivables or inventory items, in which case the partner must recognize ordinary income or loss to the extent of such items.[78]

8. Special Elections and Loss Limitations

Upon the sale of a partnership interest, the partnership can make an I.R.C. § 754 election whereby the partnership's basis in its assets are adjusted by the difference between the purchaser's basis for his/her partnership interest and the partner's share of the adjusted basis of the partnership property.[79] The amount of this adjustment only affects the new partner's basis in partnership property. Therefore, there is a special basis for each of the assets of the partnership for determining depreciation (and gain or loss) with respect to such new partner's partnership interest. Once an I.R.C. § 754 election is made, it is irrevocable for that tax year and all future tax years without the prior consent of the Internal Revenue Service.[80]

A partner's deduction for the amount of his/her loss from the partnership is limited to the amount which the partner has at risk in the partnership.[81] The I.R.C. § 469 provides that a taxpayer may not deduct losses which are generated from passive activities.[82] Any loss which has been disallowed pursuant to I.R.C. § 469 will be suspended and carried forward as a deduction in the next tax year.[83] The suspended losses are deductible against future income from such passive activity.[84] Upon the disposition of the entire interest in such passive activity, all suspended losses are allowed in full.[85] Therefore, if a partner's activity in a partnership or a member's activity in a PLLC is determined to be a passive activity, any losses from the activity will be disallowed and suspended until: (i) the partnership or PLLC has gain which can be used to offset the suspended loss, or (ii) the disposition of the entire partnership or membership interest, when the suspended basis will be deductible.

9. Self-Employment Earnings Tax

An individual's net earnings from self-employment include the individual's distributive share (whether or not distributed) of income or loss from any trade or business carried on by each partnership of which the individual is a partner.[86] The combined rate of tax for self-employment income is 15.3 percent. This rate is the aggregate of two separate taxes; Social Security and Medicare taxes. For the calendar year 2001, the Social Security tax is 12.4 percent on self-employment earnings up to $80,400 ($9,969.60 maximum tax). For the calendar year 2001, the Medicare tax is 2.9 percent on all self-employment earnings, with no maximum amount.

10. New York State Annual Filing Fee

N.Y. Tax Law § 658(c)(3) provides that an LLP/PLLC shall pay an annual filing fee equal to the product of $50 and the number of partners/members (as of the last day of the taxable year), but in no event shall the filing fee be less than $325 nor more than $10,000.[87] However, the N.Y. State Department of Taxation and Finance issued TSB-M-94 on October 25, 1994 which provides that "in the event the Internal Revenue Service were to treat single-member PLLC's as a sole proprietorship, these PLLC's would not be required to pay the annual filing fee. This rule would also apply to a foreign single-member PLLC."[88] The annual filing fee is calculated on Form IT-204-LL which is attached to the LLP/PLLC's annual partnership return.

C. Taxation of Corporations

Under the I.R.C., a corporation can be taxed under Sub-chapter C of the I.R.C. (C Corporation) or under Sub-chapter "S" of the Code (S Corporation). Regardless of whether a corporation is taxed as a C Corporation or an S Corporation, the corporation may amortize the organizational expenses of formation on a straight-line basis over the first 60 months in which the corporation conducts business.[89]

1. C Corporations

Unless a corporation makes an "S" election discussed below, the corporation is a separate taxable entity from its shareholders. A personal service corporation is taxed at a flat rate of 35 percent.[90] A personal service corporation is defined as a corporation which has as its principal business the performance of personal services, and these services are substantially performed by employee-owners.[91] Presently, a C Corporation does not have any preferential tax rate for capital gains. A C Corporation must file Form 1120 by the 15th day of the third month following the end of its tax year unless an extension is timely filed, which will extend the due date of the corporate tax return by six months.

The profits remaining after payments of its income taxes are called retained earnings. A C Corporation can declare and pay a dividend to its shareholders out of its retained earnings. A dividend is a nondeductible distribution by the C Corporation and taxable as ordinary income to the shareholders of the C Corporation. Therefore, the term "double tax" has been used to describe the taxation of a C Corporation. Since a C Corporation pays an income tax and distributes those same profits to its shareholders who pay an additional tax on the receipt of the dividends, there are two taxes paid on a single set of profits of the corporation. In addition, a C Corporation cannot accumulate and retain an unreasonable or exorbitant amount of its earnings without declaring a dividend. Otherwise, it will be subject to the accumulated earnings tax which is a tax in addition to the federal corporate income tax.[92] The accumulated earnings tax is, in essence, a penalty and is equal to the highest marginal tax rate for individual taxpayers.

Upon an audit, the IRS will scrutinize transactions between the C Corporation and its shareholders in order to determine if all such transactions are on an arm's-length basis. If the IRS discovers a transaction which is not at arm's length, the IRS will attempt to recharacterize the transaction and impose a constructive dividend. Examples of such transactions are the following: (1) unreasonable compensation paid to a shareholder/employee, (2) excessive lease payments, (3) distributions disguised as loans to shareholders, (4) loans with below market interest rates, (5) sale of assets at less than fair market value or (6) reimbursements for an excessive amount of expenses. If possible, at the time of any transaction between a C Corporation and its shareholder, the transaction should be supported utilizing independent appraisals, market comparisons and documentation including, but not limited to, execution of promissory notes, security agreements, mortgages and corporate resolutions. It is much easier to argue in support of a transaction utilizing contemporaneous documents. For instance, an independent appraisal conducted at the time of sale of an asset is much better evidence than an independent appraisal conducted three years later of the time of an audit.

In order for a corporation to be taxed as an S Corporation, an election to be treated as an S Corporation must be filed with the Internal Revenue Service. The election to be filed is set forth on Form 2553, Election by a Small Business Corporation. For newly formed corporations, this form must be filed within 75 days of the date of incorporation; or within 75 days of the first date in which the corporation had assets, issued stock and conducted business.[93] For an existing C Corporation desiring to convert to an S Corporation, the election may be filed at any time during the previous tax year or within the first 75 days of the current tax year. For example, a calendar year C Corporation which files its S election on March 10 will be treated as an S Corporation retroactively to January 1. A calendar year C Corporation which files its election on August 31 will be treated as an S Corporation as of January 1 of the following tax year. In order to be treated as an S Corporation for New York State income tax purposes, Form CT-6, Election by a Federal S Corporation to be treated as a New York S Corporation, must be filed with New York State Department of Taxation and Finance within the federal deadlines. A federal S Corporation does not have to elect "S" status for New York State tax purposes. However, a federal C Corporation cannot elect "S" status for New York State income tax purposes.

2. S Corporations

In order to elect to be taxed as an S Corporation, a corporation must meet the following eligibility requirements:

1. have not more than 75 shareholders;
2. may not have as a shareholder a person other than an estate, an eligible trust or other eligible organization who is not an individual;
3. may not have a nonresident alien as one of its shareholders; and

4. have only one class of stock, however, voting and non-voting shares of the same class are permissible.[94]

Once a corporation has elected S Corporation status, the corporation must file Form 1120S by the 15th day of the third month following the end of its tax year unless extension is timely filed, which will extend the due date of the corporate tax return by six months. Generally, an S Corporation must elect the calendar year as its tax year.[95] If the S Corporation meets a bonafide business purpose requirement, then a fiscal year may be allowed with advance permission from the Internal Revenue Service. An S Corporation can also file an I.R.C. § 444 election to be granted a fiscal year end of September 30, October 31 or November 30.

Once the S Corporation election is in place, the corporation does not pay any federal income tax. Rather, the items of income, loss, deduction and credit of the S Corporation flow through to the individual shareholders.[96] The corporation will issue a Form 1120S, Schedule K-1, to each of its shareholders providing them with their pro-rata share of the items of income, loss, deduction and credit. The shareholders will transfer those items onto a Form 1040, Schedule E, and report the income on their individual tax return. The shareholders will be taxed on the income of the S Corporation regardless of the amount of any distributions received by the shareholders. Therefore, it is possible a shareholder could be taxed on income without receiving any distribution whatsoever. The shareholders' basis in his/her stock in the S Corporation will adjust upwards and downwards according to the income, loss and distributions of the corporation.[97] As a shareholder reports income of an S Corporation on his individual tax return, his/her basis in the stock of the S Corporation will increase. As the shareholder reports losses and receives distributions from an S Corporation, his/her basis in the stock of the corporation will decrease.

There are significant tax advantages of being an S Corporation from formation, rather than subsequently converting from a C Corporation to an S Corporation. A special tax, called the "Built-In Gains Tax," is imposed on an S Corporation as a result of the sale or other disposition of an asset within ten years from the first day of the S Corporation's first tax year.[98] The tax on the Built-In Gain is at the highest corporate tax for the tax year. The Built-In Gain is equal to the difference between the fair market value of the asset on the first day of the S Corporation's first tax year and the adjusted basis of such asset on the first day of the S Corporation's first tax year.

One disadvantage of an S Corporation is the required inclusion in income of certain fringe benefits, such as health insurance premiums, received by a more than 2 percent shareholder, however the corporation is entitled to a deduction.[99]

IV. Conclusion

In conclusion, prior to the commencement of conducting a professional practice, the practitioner must weigh many factors, both tax and non-tax factors, in determining the best entity in which to conduct their professional practice. Prior to 1994, it was common to see a general partnership as the operating entity because of the advantages of partnership taxation. However, the partners of the general partnership were oftentimes single shareholder professional corporations in order to confer the benefit of limited liability upon each of the professional-owners. The general partnership/professional corporation structure was both costly and burdensome because of the multiple entities required to be formed as well as the multiple books, records and tax returns to be prepared on behalf of the practice. Since the advent of Professional Limited Liability Companies and Registered Limited Liability Partnerships, the benefits of partnership taxation and the limited liability of the individual owners can be molded into one entity which will conduct the professional practice.

Endnotes

1. N.Y. Limited Liability Company Law (LLCL) § 1201.
2. LLCL § 1206.
3. LLCL § 203(e).
4. LLCL § 1212.
5. LLCL § 1204.
6. LLCL § 417.
7. LLCL § 1213.
8. LLCL § 1210(a).
9. LLCL § 1205(a).
10. N.Y. Partnership Law § 121-1500(a).
11. L.L.P. § 121-1501.
12. L.L.P. § 121-1500(n).
13. L.L.P. §121-1500(m).
14. LLCL § 1210(a).
15. L.L.P. § 121-1500(g).
16. L.L.P. § 26.
17. N.Y. BCL § 1501.
18. BCL § 1506.
19. BCL § 402.
20. BCL § 1512.
21. BCL § 1504).
22. BCL § 403.
23. BCL § 404.

24. *Id.*
25. BCL § 601.
26. BCL § 1513.
27. BCL § 1510(a).
28. BCL § 602(b).
29. *Id.*
30. BCL § 602(c).
31. BCL § 1505(a).
32. Treas. Reg. § 301.7701-3.
33. *Id.*
34. Treas. Reg. § 301.7701-3(b)(1)(ii).
35. Treas. Reg. § 301.7701-3(b)(1)(i)).
36. Treas. Reg. § 301.7701-3(b)(2).
37. Treas. Reg. § 301.7701-3(c)(1)(iii).
38. Treas. Reg. § 301.7701-3(c)(i)(iv).
39. I.R.C. § 721(a).
40. I.R.C. § 721(b).
41. Treas. Reg. § 1.721-1(b)(1).
42. Rev. Proc. 93-27.
43. I.R.C. § 723.
44. I.R.C. § 722.
45. I.R.C. § 705(a).
46. I.R.C. §§ 705(a), 733.
47. I.R.C. § 752(a).
48. I.R.C. § 752(b).
49. I.R.C. § 733.
50. Treas. Reg. §1.752-2.
51. Treas. Reg. § 1.752-3.
52. I.R.C. § 704.
53. I.R.C. § 704(b).
54. Treas. Reg. § 1.704-1(b)(2)(i).
55. Treas. Reg. § 1.704-1(b)(2)(ii)(a).
56. Treas. Reg. § 1.704-1(b)(2)(ii)(b).
57. Treas. Reg. § 1.704-1(b)(2)(iii).
58. Treas. Reg. § 1.704-1(b)(2)(iii)(b).
59. Treas. Reg. § 1.704-1(b)(2)(iii)(c).
60. Treas. Reg. § 1.704-1(b)(2)(iii)(a).
61. I.R.C. § 731(a); Treas. Reg. § 1.731-1(a)(i).
62. I.R.C. § 733.
63. I.R.C. § 71(a).
64. I.R.C. § 77(c).
65. Treas. Reg. § 1.707-1(c).
66. Treas. Reg. § 1.731-1(a)(i).
67. I.R.C. § 752(b).
68. I.R.C. § 704(c).
69. I.R.C. § 737(b).
70. I.R.C. § 741.
71. I.R.C. § 751(a).
72. I.R.C. § 708(b)(1)(B).
73. I.R.C. § 731(a).
74. I.R.C. § 732(b).
75. I.R.C. § 731(a).
76. Treas. Reg. § 1.731-1(a)(1).
77. I.R.C. § 741.
78. I.R.C. § 751.
79. I.R.C. § 743(b).
80. I.R.C. § 754.
81. I.R.C. § 465.
82. I.R.C. § 469.
83. *Id.*
84. *Id.*
85. I.R.C. § 469(g).
86. Prop. Treas. Reg. § 1.1402(a)-2(d).
87. N.Y. Tax Law § 658(c)(3).
88. N.Y. TSB-M-94 (1994).
89. I.R.C. § 248.
90. I.R.C. § 11(b)(2).
91. I.R.C. § 469(j)(2).
92. I.R.C. § 531.
93. I.R.C. § 1362(b).
94. I.R.C. § 1631(b).
95. I.R.C. § 1378.
96. I.R.C. § 1366.
97. I.R.C. § 1367.
98. I.R.C. § 1374.
99. I.R.C. § 1372.

Shaping the Future of the Profession

Charles F. Robinson

Phil J. Shuey

April 26, 2001
Le Parker Meridien • New York City

Attorneys from around the state gathered in April, 2001 to explore the future of the legal marketplace. Multi-disciplinary practice, improving the quality of service and working more effectively with other professionals were some of the topics of discussion.

(l-r) William C. Cobb, Phil J. Shuey and Steve Krane, NYSBA President.

Steve Gallagher, NYSBA Director of the Law Office Economics and Management Dept.

Scenes f
Summer

July 2
The Algonquin

The Summer Meeting, held July 26-28 in New York City, was well attended.

Distinguished members of the profession share their knowledge at the Summer Program in New York City

The Executive Committee contemplates the future of the profession.

Shea Stadium, where the
on Friday nig

from the
Meeting

26-28
• New York City

Those in attendance listened carefully.

y.

"Take Me Out to the Ball Game"

General Practice, Solo & Small Firm Section members share in a night of baseball fun at Shea Stadium.

(l-r) Chuck Rosenstein and Jeff Fetter.

Mets beat the Phillies 6-1
ght, July 28.

(l-r) Bob and Dorothy Espach and Steve Gallagher.

The Economic Growth and Tax Relief Reconciliation Act of 2001

By Laurence Keiser

Despite all the hoopla, the 2001 Economic Growth and Tax Relief Reconciliation Act is not a good piece of tax legislation. It does create temporary relief for both wealthy and low income taxpayers, but is based on a faulty premise and will lead to enormous uncertainties.

Budget estimators (whoever they are) predicted an almost $3 trillion surplus. President Bush convinced Congress to return about $1.35 trillion (or 45 percent) to the taxpayers who, after all, generated the surplus. But many desires had to be accommodated and the competition for a piece of the reduction was fierce. As a result, almost every piece has either a deferred effective date or a phase-out. Indeed, to keep the revenue loss down to $135 trillion, the entire legislation "sunsets" (i.e., is repealed) on December 31, 2010. Income and transfer tax rates, as well as exemptions, will return to their 2001 levels. All of the legislated relief will be gone.

> *"Despite all the hoopla, the 2001 Economic Growth and Tax Relief Reconciliation Act is not a good piece of tax legislation. It does create temporary relief for both wealthy and low income taxpayers, but is based on a faulty premise and will lead to enormous uncertainties."*

And what will become of the surplus? An unprecedented rise in the stock market from 1997-2000, buoyed by the drop in the maximum capital gains tax rate in the 1997 Tax Act from 28 percent to 20 percent, caused much selling and the payment of significant taxes. Now there are predictions that with a flat stock market, gains won't continue and tax collections will drop. The surplus may be gone before we give it all back to the taxpayers.

Anyway, here are the highlights of the legislation.

Income Tax Rate Reduction

In 2001, we see a new 10 percent tax bracket which applies to the first $6,000 of taxable income for singles and $12,000 for joint filers. (Taxpayers who filed 2000 returns get half of this back in the form of a rebate check.) We also see a 0.5 percent reduction in each of the other brackets in 2001. Additional cuts will drop the brackets from 28-31-36-39.6 to 25-28-33-35 by 2006.

Under present law, personal exemptions and itemized deductions are phased out for taxpayers whose adjusted gross increases exceeds statutory thresholds. In 2006, the law begins to phase out this reduction of personal exemptions and itemized deductions (by one-third in 2006 and 2007, two-thirds in 2008 and 2009 and 100 percent in 2010).

Marriage Penalty Relief

Congress was concerned because married taxpayers could pay more income tax than they might if they were both single (because of the progressivity of income tax rates). Relief is on the way—but not until 2005—and then only phased in through 2009. The standard deduction will be increased for joint filers to twice the amount for single filers. And the 15 percent bracket will be gradually expanded for joint filers so more income will come off the top rate down to 15 percent.

Children and Education

The child tax credit, now $500 as enacted in the 1997 Act, will increase to $600 in 2001 with an eventual increase to $1,000 by 2010. The phase-out, however, remains at $75,000 for single taxpayers and $110,00 for joint filers.

The Education IRA is expanded significantly. The annual contribution increases from $500 to $2,000, the phase-out increases from $150,000 to $190,000 for joint filers, and benefits can be had for elementary education in public, private and religious schools. There is a deduction for college costs, starting at $3,000 in 2002 and rising to $4,000 in 2003 and 2004. It expires after 2004. The phase-out is very low ($65,000 for single filers, $130,000 for joint filers.)

College Savings (I.R.C. Section 529) plans also become more attractive as the earnings on the account will not be subject to tax as long as distributions are used to pay the education expenses. This is well worth exploring for clients of all wealth levels.

Transfer Tax Reductions

As of January 1, 2002, the Estate, Gift and Generation-Skipping Transfer (GST) exemption increases to $1 million. The top rate for each tax drops from 55 percent to 50 percent. The rates continue to gradually drop to 45 by 2007. The estate and GST exemptions increase to $1.5 million in 2004, $2 million in 2006 and $3.5 million in 2009 and those taxes are repealed in 2010. The gift tax exemption remains at $1 million throughout; the gift tax is not repealed. In 2010, the rate drops to the maximum income tax rate (35 percent).

When the estate tax is repealed, the provision allowing for a step-up in basis at death is also repealed. The new rule for basis will then be the lower of fair market value or the decedent's adjusted basis. Each estate will have $1.3 million of allowable step-up, which can be allocated to assets distributed. In addition, there is a $3 million step-up for assets which pass to a surviving spouse. Some assets (such as income in respect of a decedent) don't qualify for step-up.

It becomes the duty of the executor (with a significant penalty for non-compliance) to report to the heir and to the IRS the heir's new basis in the inherited asset.

The Relief Act phases out the available credit for death taxes paid to states over a four-year period. This will increase the federal tax payment for most estates. Starting in 2006, the state taxes paid will be allowed as a deduction. Note that states that collect a death tax equal to the federal credit allowed will be adversely affected because the federal credit will be inapplicable. New York law references the Internal Revenue Code as of July 22, 1998. Consequently, New York's estate tax collection will go on. New York estates will, however, be "out-of-pocket" because a full credit against federal tax will no longer be allowed.

As a result, estate planning becomes more complicated (unless your client can pinpoint his or her year of death). Formula credit shelter provisions in existing wills should automatically adjust for the increase in exemptions. For the next few years, estate planning techniques which have become widely accepted (such as Family Limited Partnerships, Grantor Retained Annuity Trusts and Qualified Personal Residence Trusts) should continue to flourish.

Retirement Benefits

On the lower end, IRA contributions will rise to $3,000 in 2002, ultimately reaching $5,000 by 2008 (with a small additional allowance for taxpayers over 50). Maximum Sec. 401(k) contributions will rise to $11,000 in 2002 and ultimately reach $15,000 by 2008.

On the upper end, plan contribution maximums will increase. In 2002, the maximum contribution to a defined contribution plan will increase to $40,000 (from $35,000) and to a defined benefit plan to $160,000 (from $140,000). In addition, the "top-heavy" rules will be relaxed somewhat, allowing for greater deductions for higher paid employees (i.e., the principals of the business).

"There are many beneficial provisions in the 2001 Relief Act. Perhaps more needs to be done. Indeed there are several new tax acts awaiting Congressional review. All of these items, including meaningful AMT relief, are worthy; but the budget cupboard is now bare."

Alternative Minimum Tax

There is limited AMT relief. The exemption will increase by $2,000 for single taxpayers and $4,000 for joint filers for 2001 through 2004 only.

Many more taxpayers will be subject to AMT, however, since every change that reduces regular income tax makes it more likely that the AMT will apply.

Conclusion

There are many beneficial provisions in the 2001 Relief Act. Perhaps more needs to be done. Indeed there are several new tax acts awaiting Congressional review. All of these items, including meaningful AMT relief, are worthy; but the budget cupboard is now bare. New tax cuts will have to be matched by tax increases and this just doesn't seem feasible. The balance of power in Congress could shift by 2002 or 2004. Or a Democratic President could be elected in 2004. Any of these could create a revisit of the legislation. Stay tuned.

How to Avoid a Grievance: Preventive Medicine

By Mark Nerenberg

The vast majority of grievance complaints against attorneys arise out of alleged negligence and the underlying representation in the high-volume practices such as matrimonial, personal injury and real estate matters. The attorneys who get the most serious complaints are those holding clients' escrow funds, namely in estate matters, real estate and personal injury cases. Although these types of cases are the most frequently reported, a common thread that runs through all grievance complaints is that of the dissatisfied client. While this article will use matrimonial, personal injury and real estate matters as examples, the practical suggestions can be applied to all areas of representation.

It should be noted parenthetically that the most common types of complaints revolve around the failure to communicate. That is: "My lawyer doesn't answer my phone calls or letters." Every attorney, of course, has a duty to respond to reasonable requests for information from the client, and in order to avoid these types of complaints, lawyers should promptly answer their telephone messages and letters from their clients. The least common type of complaints, but the most worrisome, are those in which there is directly or indirectly an accusation that the attorney has mishandled client funds, namely:" My lawyer won't give me my money." Most complaints are closed without sanction, but lawyers who are proven to have intentionally misappropriated clients' funds usually get disbarred.

In order to avoid the feared grievance complaint, there are several practical points that will go a long way in satisfying your client and avoiding a run-in with the grievance committee:

1. Maintain reasonable communication with clients and return telephone calls within 24 hours;
2. Return telephone calls deemed "urgent" as soon as possible;
3. Provide clients with copies of all correspondence and pleadings ("paper them to death");
4. Explain any court decision or memorandum and the impact of the Court Order upon your client;
5. Schedule periodic "face to face" conferences with the client.

While this is not a complete and all-inclusive list, if an attorney follows these basic points, grievance complaints, to a large extent, can be avoided.

Clients come to you for two essential reasons:

1. They are facing a situation which they cannot resolve themselves and they begrudgingly seek your expertise and rely on you to provide appropriate advice to address their concerns; or
2. They are injured/aggrieved and need your assistance.

"It should be noted parenthetically that the most common types of complaints revolve around the failure to communicate. That is: 'My lawyer doesn't answer my phone calls or letters.'"

Your initial meeting with a prospective client should form the basis of your decision to accept or decline the representation. You should always document your meeting and promptly confirm in writing the conversation, as well as your determination to accept or decline the matter. In the event that you detect that the prospective client has unreasonable/unattainable expectations or if you have any doubt about the veracity of the situation as presented, consider carefully before taking on this matter.

Upon engagement, it is your unqualified responsibility to take all necessary steps to insure that the rights of your client are appropriately vindicated or defended. If you fall below the standard of care or appear to have done so, a grievance complaint against you will likely ensue. Keep in mind that you will ultimately be judged based on objective standards in the face of a hostile grievance committee. For this reason, it is essential to ensure that you have sufficiently documented your file in accordance with discussions with the client from the outset. The mechanics of the suggested documentation at the incipient stage of your retention is as follows:

Your initial meeting with the client should form the basis of your agreement to accept the case or decline representation. In either event, a letter should be promptly transcribed evidencing your decision and confirming your discussion. Should you decide to accept the assignment, I would caution not to guarantee (verbally or in writing) any results, no matter what your experience in similar matters has revealed. Our society generally finds it difficult to accept that attaining a desired result is not possible. I can almost guarantee that if you fail to achieve your guarantee, you will be facing a grievance complaint. As such, your initial meeting should be conducted in a manner that suggests that while you have specific goals, there is a possibility that some, and possibly all, may not be met. Make sure your written agreement to accept retention (commonly referred to as a "Retainer Letter") specifically delineates the scope of your representation and duties, sets forth your goals and means of achieving the specified goals, and incorporates the specific fee arrangement you have arrived upon. The term "expenses" should be specifically defined because most clients are unaware that this can represent a large sum of money during the course of litigation.

There are many reasons for setting forth the specific duties in your first correspondence. Although you legitimately thought you were only retained to handle a certain aspect of the case, you will be in an indefensible position if you have not spelled out the (limited) scope of your representation at the outset. In the context of engagements, I would also suggest that if there is the slightest possibility that a conflict of interest exists, decline the matter. Although the courts uphold some waivers of conflict in some circumstances, in the context of defending a grievance complaint, the mere specter of impropriety in this area is usually fatal to an otherwise viable defense.

The practice of accepting retention pending investigation raises some additional issues. In essence, you should clearly set forth the nature of the investigation you will attempt to conduct and a relative time frame for completion of your investigation. Generally, this letter should incorporate all aspects of a Retainer Letter as set forth above. However, once you have decided to take on or decline to handle the case, you must write a follow-up letter in either event. If your investigation reveals a limited possibility for success/recovery and you do not wish to take on the matter and do not evidence this in writing, this is the basis of inescapable culpability in the face of the grievance complaint.

If you decide not to handle a matter on behalf of a prospective client, it is critical to send a confirmatory letter which unequivocally states this. Although you are not technically required to do so, it is in your best interest to set forth the reasons you are declining representation and the date that the statute of limitations may run (if applicable). It is also advisable to suggest that the prospective client seek out the advice of another attorney to consult and review the case. This will serve as highly favorable evidence in the event that a grievance complaint is lodged against you at a later date. There are many instances in which your failure to properly analyze and review the merits of a case at the outset could give rise to a grievance complaint. While the grievance complaints are usually defensible, you are still involved in time-consuming discovery and an emotionally trying bout with the grievance committee. This, however, could usually be avoided with defensive measures at the outset of your initial meeting with the client and appropriate documentation.

> *"[I]t is imperative that you document all discussions and decisions through a letter to the client which evidences the agreement/awareness of the strategy."*

Once you have undertaken your representation, it is essential to continue to keep your client advised of the status and progress of the matter. In this regard, I suggest that you schedule a meeting whenever there are significant developments or any contemplated changes in the strategy you have initially employed. While you should make recommendations on how to proceed, you should also clearly advise the client of the ramifications of your strategic decision and solicit their input and ultimate agreement with the course of action you will take. Once again, it is imperative that you document all discussions and decisions through a letter to the client which evidences the agreement/awareness of the strategy. Although less persuasive in the context of a grievance complaint, many practitioners prefer to dictate a dated memo to the client file.

A myriad of grievance complaints arise when the client is not advised on a periodic basis of possible obstacles to achieving the goals set at your initial meeting. While the deterioration of the case may not be desirable, the probability of facing a grievance complaint as a result of this is lessened substantially if your client is not "shocked" by the status. Simply stated, the grievance complaint becomes much more defensible if your records reflect that your client was cognizant of the posture of a matter through periodic meetings, notes in your file and/or written reports.

Upon completion of your representation, you should immediately memorialize your disengagement in correspondence. This is particularly essential if you are handling several distinct and separate matters for a given client, to ensure that they are not under the impression that there are any outstanding issues with respect to the instant and now concluded matter.

I would also recommend in your closing letter that you briefly provide a synopsis of the resolution for purposes of clarity and a further conveyance of finality. I would recommend, particularly in the case of an underlying personal injury settlement on behalf of your client, that you add some wording which confirms that the client is and was fully aware that he may have obtained a greater or lesser settlement had the lawsuit continued, but was cognizant and in agreement with (in the nature of an informed consent) the determination to compromise through settlement.

Use your common sense when making decisions in the context of strategy and selecting your clients. Attempt to act in a reasonable manner with all parties to maintain your credibility. If you feel that the situation you are in has become an inextricable problem, you should seek assistance as soon as possible. Many times, a lawyer will recognize that a matter is spiraling downward and attempts quick fixes which backfire or appear to be irrational. Such reactions to a problem can be devastating to you when called upon to explain the basis for your course of conduct before a grievance committee. If you find yourself in this predicament, you should speak with the client and enlist advice from colleagues who may be able to offer valid solutions from an objective perspective.

Lawyering has evolved into a highly competitive and customer service-oriented environment. This trend has escalated, in my opinion, over the past decade. If you are not doing so already, you must view yourself as a service provider and expect to be held to a higher standard by your client than that imposed by law. To think otherwise is a complete denial of the reality of the practice of law today and could lead to an extremely unpleasant experience with the grievance committee and a potentially dangerous outcome. Your product is your final result. Your client will decide if the product is acceptable—but if you do not come close to your initial goal, you will find yourself in a precarious position.

"Use your common sense when making decisions in the context of strategy and selecting your clients."

The purpose of this article is to make some practical suggestions which will help to avoid an unpleasant experience by acting thoughtfully throughout. Preventive measures from the outset of your initial meeting with the client will more often than not avoid an emotionally stressful confrontation with the grievance committee.

Making Sure the Ex-Spouse Is Also the Ex-Beneficiary—The Interplay of Matrimonial Law and Estates Law

By Dwayne Weissman

The N.Y. State Legislature has addressed the effect of divorce on testamentary dispositions. N.Y. Estates, Powers and Trusts Law (EPTL) 5-1.4 provides that a subsequent divorce revokes any disposition by will to the former spouse.

> **Section 5-1.4. Revocatory effect of divorce, annulment or declaration of nullity, or dissolution of marriage on disposition, appointment or other provision in will to former spouse.**
>
> (a) If, after executing a will, the testator is divorced, his marriage is annulled or its nullity declared or such marriage is dissolved on the ground of absence the divorce, annulment, declaration of nullity or dissolution revokes any disposition or appointment of property made by the will to the former spouse and any provision therein naming the former spouse as executor or trustee unless the will expressly provides otherwise, and the provisions, dispositions and appointments made in such will shall take effect as if such former spouse had died immediately before such testator. If a provision, disposition or appointment is revoked solely by this section, it shall be revived by testator's remarriage to the former spouse.
>
> (b) The provisions of this section apply to the will of a testator who dies on or after its effective date, notwithstanding that the will was executed and the divorce, annulment, declaration of nullity or dissolution was procured prior thereto.

The N.Y. State Legislature has not similarly addressed the effect of divorce on other dispositions.

A. Bank Accounts in Trust Form

In re Totten,[1] the Court of Appeals enunciated that:

> (A) deposit by one person of his own money, in his own name as trustee for another, standing alone, does not establish an irrevocable trust during the lifetime of the depositor. It is a tentative trust merely, revocable at will, until the depositor dies or completes the gift in his lifetime by some unequivocal act or declaration, such as delivery of the pass book or notice to the beneficiary. In case the depositor dies before the beneficiary without revocation, or some decisive act or declaration of disaffirmance, the presumption arises that an absolute trust was created as to the balance on hand at the death of the depositor.

This "rule" was codified in EPTL 7 through 7-5.8 which set forth the terms and conditions under which a "Totten trust account" (officially, Bank Account In Trust Form) is created and revoked.

> **Section 7-5.2. Terms of a trust account.**
>
> The funds in a trust account, which shall include any dividends or interest thereon shall be trust funds subject to the following terms:
>
> (1) The trust can be revoked, terminated or modified by the depositor during his lifetime only by means of, and to the extent of, withdrawals from or charges against the trust account made or authorized by the depositor or by a writing which specifically names the beneficiary and the financial institution. The writing shall be acknowledged or proved in the manner required to entitle conveyances of real property to be recorded, and shall be filed with the financial institution wherein the account is maintained.
>
> (2) A trust can be revoked, terminated or modified by the depositor's will only by means of, and to the extent of, an express direction concerning such trust account, which must be described in the will as being in trust for a named beneficiary in a named financial institution. Where the depositor has more than one trust account for a particular beneficiary in a particular financial

institution, such a direction will affect all such accounts, unless the direction is limited to one or more accounts specifically identified by account number in addition to the foregoing requirements. A testamentary revocation, termination or modification under this paragraph can be effected by express words of revocation, termination or modification, or by a specific bequest of the trust account, or any part of it, to someone other than the beneficiary. A bequest of part of a trust account shall operate as a pro tanto revocation to the extent of the bequest.

(3) If the depositor survives the beneficiary, the trust shall terminate and title to the funds shall continue in the depositor free and clear of the trust.

(4) If the beneficiary survives the depositor, and the depositor's will contains no provision revoking, terminating or modifying the trust account under paragraph (2), the trust shall terminate and title to the funds shall vest in the beneficiary free and clear of the trust.

(5) If the beneficiary survives the depositor and the depositor's will contains language sufficient under paragraph two of this section to revoke, terminate or modify the trust in whole or in part that part of the trust which is affected shall terminate and title to the funds shall be subject to disposition by the depositor's will, free and clear of the trust.

A subsequent divorce does not, in and of itself, revoke a "Totten trust" beneficiary designation in favor of the former spouse.[2]

B. Beneficiaries of Individual Retirement Accounts

The designation of an IRA beneficiary is governed by EPTL 13-3.2.

Rights of beneficiaries of pension, retirement, death benefit, stock bonus and profit-sharing plans, systems or trusts and of beneficiaries of annuities and supplemental insurance contracts. The requirements of the designation are set forth in paragraph (e) of said statute:

(e) A designation of a beneficiary or payee to receive payment upon death of the person making the designation or another must be made in writing and signed by the person making the designation and be:

(1) Agreed to by the employer or made in accordance with the rules prescribed for the pension, retirement, death benefit, stock bonus or profit-sharing plan, system or trust.

(2) Agreed to by the insurance company or the savings bank authorized to conduct the business of life insurance, as the case may be.

A subsequent divorce does not, in and of itself, revoke an IRA beneficiary designation in favor of the former spouse.[3]

C. Beneficiaries of Life Insurance Policies

The designation of a life insurance policy beneficiary is also governed by EXPEL.[4]

In *McCarthy v. Aetna Life Insurance Co.*,[5] a couple married in 1972 and Mr. Kapcar designated his bride as beneficiary of his life insurance policy. Shortly thereafter, Mr. Kapcar was diagnosed with multiple sclerosis and he became blind in 1974. Husband and wife separated in 1977 and divorced in 1978. Mr. Kapcar lived with his father from 1977 until his death in 1984.

Mr. Kapcar left a will in which he gave all his property—including insurance benefits—to his caregiver father. Nonetheless, the Court of Appeals awarded the insurance proceeds to the ex-wife stating that the method prescribed by the insurance contract must be followed in order to effect a change of beneficiary. The Court found that the decedent never communicated an intended change of beneficiary to the insurer.

Perhaps New York's highest court did not permit "bad facts (to) make bad law." The Court explained that:

> To hold that a change in beneficiary may be made by testamentary disposition alone would open up a serious question as to payment of life insurance policies. It is in the public interest that an insurance company may pay a loss to the beneficiary designated in the policy as promptly after the death of insured as may reasonably be done. If

> there is uncertainty as to the beneficiary upon the death of insured, in all cases where the right to change the beneficiary had been reserved there would always be a question as to whom the proceeds of the insurance should be paid. If paid to the beneficiary, a will might later be probated designating a different disposition of the fund, and it would be a risk that few companies would be willing to take.[6]

Obviously, a subsequent divorce does not, in and of itself, revoke a life insurance beneficiary designation in favor of the former spouse.

Conclusion

We must be aware of our clients' asset structure and marital status, etc., so that we can counsel as to what must be done to fulfill their desires both during life and thereafter.

When clients come in asking for new wills, we must counsel them regarding Totten trusts, IRA accounts, life insurance policies, annuities, revocable/irrevocable trusts, jointly owned property, etc.—to make sure that the ex-spouse is also the ex-beneficiary.

Endnotes

1. 179 N.Y. 112, 125-26 (1904).
2. *See Eredics v. Chase Manhattan Bank*, N.Y.L.J., Oct. 20, 2000, p. 34, col. 4 (Sup. Ct., Nassau Co.).
3. *See Freedman v. Freedman*, N.Y.L.J., Oct. 31, 2000, p. 35, col. 4 (E.D.N.Y).
4. EPTL 13-3.2.
5. 92 N.Y.2d 436, 681 N.Y.S.2d 790 (1998).
6. 92 N.Y.2d at 441, 681 N.Y.S.2d at 793-794.

New Amendments to Code of Professional Responsibility Address Lawyers' Relationships with Nonlegal Professionals

By Kathleen R. Baxter

On July 23, 2001, the Appellate Division released an order amending the Disciplinary Rules of the Code of Professional Responsibility, effective November 1, 2001, to govern nonlegal services that are provided by lawyers and to regulate lawyers' contractual relationships with nonlegal professionals. New York thus has become the first state in the nation to address lawyer participation in multi-disciplinary practices, commonly known as MDPs.

The new rules initially were proposed by NYSBA's Special Committee on the Law Governing Firm Structure and Operation (the MacCrate Committee) in its report entitled "Preserving the Core Values of the American Legal Profession." That report (1) examined the current state of the American legal profession including practice settings, the effects of specialization and technology and relationships with nonlawyer professionals; (2) analyzed the globalization of American legal practice and the growth of MDPs in other countries; and (3) analyzed the professional responsibilities of lawyers and recommended changes to the law governing the legal profession to preserve the profession's "core values." The report was approved by the NYSBA House of Delegates in June 2000; the amendments to the Code of Professional Responsibility were approved by the House in November 2000.[1]

DR 1-106

The first new rule, DR 1-106, provides:

> DR 1-106 Responsibilities Regarding Nonlegal Services
>
> A. With respect to lawyers or law firms providing nonlegal services to clients or other persons:
>
> 1. A lawyer or law firm that provides nonlegal services to a person that are not distinct from legal services being provided to that person by the lawyer or law firm is subject to these Disciplinary Rules with respect to the provision of both legal and nonlegal services.
>
> 2. A lawyer or law firm that provides nonlegal services to a person that are distinct from legal services being provided to that person by the lawyer or law firm is subject to these Disciplinary Rules with respect to the nonlegal services if the person receiving the services could reasonably believe that the nonlegal services are the subject of an attorney-client relationship.
>
> 3. A lawyer or law firm that is an owner, controlling party or agent of, or that is otherwise affiliated with, an entity that the lawyer or law firm knows to be providing nonlegal services to a person, is subject to these Disciplinary Rules with respect to the nonlegal services if the person receiving the services could reasonably believe that the nonlegal services are the subject of an attorney-client relationship.
>
> 4. For purposes of DR 1-106(A)(2) and (A)(3), it will be presumed that the person receiving nonlegal services believes the services to be the subject of an attorney-client relationship unless the lawyer or law firm has advised the person receiving the services in writing that the services are not legal services and that the protection of an attorney-client relationship does not exist with respect to the nonlegal services, or if the interest of the lawyer or law firm in the entity providing nonlegal services is de minimis.
>
> B. Notwithstanding the provisions of DR 106(A), a lawyer or law firm that is an owner, controlling party, agent, or is otherwise affiliated with an entity that the lawyer or law firm knows is providing nonlegal services to a person shall not permit any nonlawyer providing such services or affiliated with that entity to direct or regulate the professional judgment of the lawyer or law firm in rendering legal services to any person, or to cause the lawyer or

> law firm to compromise its duty under DR 4-101(B) and (D) with respect to the confidences and secrets of a client receiving legal services.
>
> C. For purposes of this section, "nonlegal services" shall mean those services that lawyers may lawfully provide and that are not prohibited as an unauthorized practice of law when provided by a nonlawyer.

This rule is intended to furnish guidance to lawyers and law firms that provide their clients with nonlegal services. The provision of nonlegal services by lawyers is not new; however, in New York, as in most states, guidance concerning this practice typically has been provided by ethics committee opinions that interpreted existing disciplinary rules, such as the Code's conflict of interest provisions.[2] DR 1-106 now makes clear that a lawyer or law firm providing nonlegal services to clients is subject to the Code of Professional Responsibility with respect to those nonlegal services "if the person receiving the services could reasonably believe that the nonlegal services are the subject of an attorney-client relationship." For purposes of this rule, there is a presumption that the person believes the services are the subject of an attorney-client relationship unless the lawyer advises the client in writing that the services are "not legal services and that the protection of an attorney-client relationship does not exist with respect to the nonlegal services."

DR 1-107

New DR 1-107 establishes guidelines for lawyers who enter into relationships with nonlawyer professionals. The relationship between lawyers and nonlawyer professionals has been at the heart of the nationwide debate over MDP; under no circumstances may a lawyer permit a nonlawyer to direct the lawyer's professional judgment in providing legal services to a client. The concerns regarding the importance of the lawyer's independence were underscored by the Appellate Division with its own addition to DR 1-107 as proposed by the NYSBA. The language added by the Appellate Division reads as follows:

> A. The practice of law has an essential tradition of complete independence and uncompromised loyalty to those it serves. Recognizing this tradition, clients of lawyers practicing in New York State are guaranteed "independent professional judgment and undivided loyalty uncompromised by conflicts of interest." Indeed, these guarantees represent the very foundation of the profession and allow and foster its continued role as a protector of the system of law. Therefore, a lawyer must remain completely responsible for his or her own independent professional judgment, maintain the confidences and secrets of clients, preserve funds of clients and third parties in his or her control, and otherwise comply with the legal and ethical principles governing lawyers in New York State.
>
> Multi-disciplinary practice between lawyers and nonlawyers is incompatible with the core values of the profession and therefore, a strict division between services provided by lawyers and those provided by nonlawyers is essential to protect those values.

At the same time, it is generally recognized that clients may derive benefits from cooperative relationships between lawyers and nonlawyer professionals—particularly, "the benefit of coordinated professional services from two providers that have a history and track record of working together on behalf of common clients."[3] As an example, the client of a law firm with an environmental law department may benefit from the firm's cooperative arrangement with an engineering consulting firm to provide environmental engineering services to that client.

In order to strike a balance between the interest in protecting the core values of the legal profession and the client benefit that may be derived from providing coordinated services to clients, new DR 1-107 permits a lawyer or law firm to enter into a "contractual relationship" with a nonlegal professional service firm if:

> 1. The profession of the nonlegal professional or nonlegal professional service firm is included in a list jointly established and maintained by the Appellate Divisions pursuant to Section 1205.3 of the Joint Appellate Division rules.
>
> 2. The lawyer or law firm neither grants to the nonlegal professional or nonlegal professional service firm, nor permits such person or firm to obtain, hold or exercise, directly or indirectly, any ownership or investment interest in, or managerial or supervisory right, power or position in connection with the prac-

tice of law by the lawyer or law firm, nor, as provided in section 1200.8(b)(1), shares legal fees with a nonlawyer or receives or gives any monetary or other tangible benefit for giving or receiving a referral; and

3. The fact that the contractual relationship exists is disclosed by the lawyer or law firm to any client of the lawyer or law firm before the client is referred to the nonlegal professional service firm, or to any client of the nonlegal professional service firm before that client receives legal services from the lawyer or law firm; and the client has given informed written consent and has been provided with a copy of the "Statement of Client's Rights In Cooperative Business Arrangements" pursuant to section 1205.4 of the Joint Appellate Division rules.[4]

"Through the publication of the MacCrate Report and the adoption of rules to govern the relationships between lawyers and nonlawyer professionals, the NYSBA and the courts have played a significant role in shaping the direction of multi-disciplinary practice in the United States."

Under a separate set of Appellate Division rules,[5] the Appellate Division will develop and maintain a list of professions with which a lawyer or law firm may enter a contractual relationship. This set of rules also includes a "Statement of Client's Rights in Cooperative Business Relationships" that must be provided by a lawyer to a client under DR 1-107(A)(3).[6]

Advertising

The new rules contain related amendments to the provisions governing lawyer advertising. An amendment to DR 2-101 makes clear that a lawyer or law firm may advertise the availability of nonlegal services provided by the lawyer or an entity owned by the lawyer, as well as contractual relationships with nonlawyer professionals or professional service firms. Previously, ethics opinions had interpreted the Code as prohibiting the advertising of ancillary services, as it was believed that the nonlegal business should not be used as a "feeder" for the legal practice. In the view of the MacCrate Committee, "such precautions are unnecessary and contrary to the public interest in receiving accurate and relevant information relating to the abilities, qualifications and services offered by lawyers."[7]

Conclusion

Through the publication of the MacCrate Report and the adoption of rules to govern the relationships between lawyers and nonlawyer professionals, the NYSBA and the courts have played a significant role in shaping the direction of multi-disciplinary practice in the United States. In one respect, the new rules are not ground-breaking; as the MacCrate Report observes, lawyers long have provided nonlegal services to their clients and have entered into strategic alliances with nonlegal professionals.[8] However, the rules provide needed guidance for lawyers engaged in these practices, facilitating lawyers' relationships with nonlegal professionals while protecting the legal profession's core values: the exercise of independent professional judgment and undivided loyalty to the client.

Endnotes

1. The House approved amendments to the Disciplinary Rules and the Ethical Considerations contained in the Code, contingent upon the adoption of the Disciplinary Rules by the Appellate Division. The Appellate Division does not adopt Ethical Considerations, which are aspirational in nature and not mandatory. As the Appellate Division has adopted the amendments to the Disciplinary Rules, the amendments to the Ethical Considerations approved by the House in November 2000 will be added to the Code as well.
2. *See, e.g.,* N.Y. State Ethics Op. 711 (1998) (lawyer–insurance agent); N.Y. State Ethics Op. 636 (1992) (lawyer–legal forms business); N.Y. State Ethics Op. 595 (1988) (lawyer–title abstract company); N.Y. State Ethics Op. 493 (1978) (lawyer–real estate broker).
3. Preserving the Core Values of the American Legal Profession, p. 343 (2000).
4. DR 1-107(A)(1)-(3).
5. 22 N.Y.C.R.R. part 1205.
6. STATEMENT OF CLIENT'S RIGHTS IN COOPERATIVE BUSINESS ARRANGEMENTS

   Your lawyer is providing you with this document to explain how your rights may be affected by the referral of your particular matter by your lawyer to a nonlegal service provider, or by the referral of your particular matter by a nonlegal service provider to your lawyer.

   To help avoid any misunderstanding between you and your lawyer please read this document carefully. If you have any questions about these rights, do not hesitate to ask your lawyer.

   Your lawyer has entered into a contractual relationship with a nonlegal professional or professional service firm, in the form of a cooperative business arrangement which may include sharing of costs and expenses, to provide legal and nonlegal services. Such an arrangement may substantially affect your rights in a number of respects. Specifically, you are advised:

1. A lawyer's clients are guaranteed the independent professional judgment and undivided loyalty of the lawyer, uncompromised by conflicts of interest. The lawyer's business arrangement with a provider of nonlegal services may not diminish these rights.
2. Confidences and secrets imparted by a client to a lawyer are protected by the attorney/client privilege and may not be disclosed by the lawyer as part of a referral to a nonlegal service provider without the separate written consent of the client.
3. The protections afforded to a client by the attorney/client privilege may not carry over to dealings between the client and a nonlegal service provider. Information that would be protected as a confidence or secret, if imparted by the client to a lawyer, may not be so protected when disclosed by the client to a nonlegal service provider. Under some circumstances, the nonlegal service provider may be required by statute or a code of ethics to make disclosure to a government agency.
4. Even where a lawyer refers a client to a nonlegal service provider for assistance in financial matters, the lawyer's obligation to preserve and safeguard client funds in his or her possession continues.

You have the right to consult with an independent lawyer or other third party before signing this agreement.

Client's Consent:

I have read the above Statement of Client's Rights in Cooperative Business Arrangements and I consent to the referral of my particular matter in accordance with that Statement.

____

Client's signature

____

Date

7. Preserving the Core Values of the Legal Profession, p. 339 (2000).
8. *Id.*, pp. 97-107, 326, 342-43 (2000).

Kathleen R. Baxter is Counsel to the New York State Bar Association.

GP/Solo Electronic Community

By Stephen P. Gallagher

We are all finding that modern technologies and particularly the Internet are creating new ways to conduct business. The idea of an autonomous, sole practitioner may become a thing of the past, while the notion of a sole practitioner working with multiple partners in both formal and informal reciprocal relationships is becoming commonplace. In the not-too-distant future, success of your law practice may depend on your networking skills, so the General Practice, Solo & Small Firm Section invites you to join with us in building this electronic community.

To get started, you should visit the GP/Solo Web site at: **http://www.nysba.org/sections/gp/index.html** and sign up for the section's electronic newsletter *E-Brief* (soon to be renamed *wEbrief*). This newsletter goes out on the second Tuesday of the month, and it can only be received if you have an e-mail address. An HTML version of the newsletter is placed on the Web site at: **http://www.nysba.org/netplus/ebrief_archive.htm**. One of the key features of this newsletter is that the content comes directly from section members. Leonard E. Sienko, Jr. from Hancock, N.Y., shares a wealth of Web knowledge each month, and some of his items from the last *E-Brief* include the following:

wEbrief for August, 2001—Gramm-Leach-Bliley Act

Not very interested in the Federal Trade Commission?

http://www.ftc.gov/

They're interested in you, even if you're a sole practitioner or member of a small firm. Under Title V of the Gramm-Leach-Bliley Act, 15 U.S.C. Sec. 6801, et sec., (GLB) businesses engaged in "financial activities" were required to mail a privacy policy to all of their customers by July 1, 2001. The FTC interprets the term "financial activities" very broadly. Credit card companies, banks, travel agents, car dealers and accountants all fit the definition. According to the FTC, lawyers practicing tax law, estate planning, domestic relations, real estate and bankruptcy law must write a privacy policy, send a privacy notice to all their clients and post it on their Web site. Check out GLB at:

http://www.ftc.gov/privacy/glbact/index.html

NYSBA's position is that this interpretation of the Act is unwarranted and potentially damaging to lawyer-client relationships, and that lawyers therefore should be exempt from the privacy notice requirement. See NYSBA President Steve Krane's letter to the FTC on the issue of exemption.

http://www.nysba.org/media/newsreleases

wEbrief for August, 2001—crashDATABASE.com

Air Safety Online's crashDATABASE.com aviation accident search utility is a searchable database of every commercial airline accident with more than 10 fatalities since 1970. Included in the database are more than 1,500 commercial airline accident records, large and small, covering the years of 1970 through 2001.

You may search by airline, type of aircraft, date of accident, or customize your search by location or other criteria.

http://www.crashdatabase.com/

wEbrief for August, 2001—Free Merck Medical Manuals

The Merck Manual of Diagnosis and Therapy, 17th Edition, a general medical textbook, continuously published longer than any other English language general medical textbook, is provided on its web site free of charge for unlimited use.

The Merck Manual of Geriatrics, 3rd Edition, Fall of 2000, includes information on nursing care, pharmacy issues, discussions of the best drugs for the elderly, dementia, Alzheimer's disease, rehabilitation, respiratory failure, and managed care. The 3rd Edition is also provided free of charge for unlimited use.

The Merck Manual of Medical Information Home Edition, September 1997, uses everyday language to present information about diseases, diagnosis, prevention, and treatment. Selected sections of The Home Edition are currently online and searchable through the site-wide search facility.

http://www.merck.com/pubs/

wEbrief for August, 2001—Office of the Clerk

The Office of the Clerk of the U.S. House of Representatives maintains a comprehensive On-line Information Center. At this site, you can obtain copies of House documents that the Clerk makes available as part of the official duties of this office, including public disclosure. You can also find historical information about the House of Representatives and information about its Members and Committees.

Quick Links to the most frequently requested information include Bill Summary and Status—107th (THOMAS); House Calendar (GPO); Congressional Biographical Directory House Member Information Congressional Calendar (2001) (House); Congressional Record (THOMAS); Legislative Information System (Congress Staff); Lobbying Registration Information; and Members' Web Sites (House).

http://clerkweb.house.gov/

Don't miss the U.S. House of Representatives Roll Call Votes for the 107th Congress—1st Session (2001)—as compiled through the electronic voting machine by the House Tally Clerks.

http://clerkweb.house.gov/evs/2001/ROLL

wEbrief for August 2001—Federal Election Commission

The Federal Election Commission web site contains a wealth of information about law, politics, and money.

http://www.fec.gov/

Of special note are the Campaign Finance Law Resources: including Legal Documents, Commission Regulations, Advisory Opinions, Recent and Ongoing Rulemakings/Regulations (Federal Register Notices), Court Case Abstracts, FEC and State Campaign Finance Laws.

http://www.fec.gov/finance_law.html

View actual financial disclosure reports filed by House, Senate and Presidential campaigns, Parties and PACs from 1993 to the present.

View financial disclosure reports filed electronically by House and Presidential campaigns, Parties and PACs.

Search the Disclosure DataBase for Campaign/Committee Summaries and selected contributions to House, Senate and Presidential campaigns, Parties and PACs in the 1997-98 and 1999-2000 election cycles. Results of these queries are also linked to the imaging system so you can view the actual financial reports filed by campaigns and committees.

http://www.fec.gov/finance_reports.html

One of the advantages of accessing information online can be demonstrated with this document. As you read this paper copy of my work, you are unable to access the information I am referring to. I give you the location of the Web sites (URLs), but you are unable to see what I am referring to. If you go to our Web site to read this article, you will be able to link to: the Gramm-Leach-Bliley Act, 15 U.S.C. Sec. 6801; the Air Safety Online's crashDATABASE.com aviation accident search utility; the Merck Manual of Diagnosis and Therapy, or any of the other resources Lenny Sienko has chosen for us to review.

Knowledge management refers to any initiative that focuses on knowledge as a primary resource of an organization, and through the use of its electronic communities, the GP/Solo Section is working to make knowledge more productive for section members. The *E-Brief* newsletter can be received via e-mail, and then it is published to the Web site.

If anyone has questions on how to receive this e-newsletter, please call Stephen P. Gallagher in the Law Office Economics and Management Resource Center at 518-487-5595. This article will also be placed as an HTML document on the GP/Solo Web site.

Stephen P. Gallagher is the Director of the Law Office Economics and Management Department at the New York State Bar Association.

Section Committees & Chairs

Committee on Alternative Dispute Resolution
Irwin Kahn
299 Broadway, Suite 803
New York, NY 10007

Committee on Business Law
Vacant

Committee on Bylaws
Hon. Joel K. Asarch
99 Main Street
J.C. 29
Hempstead, NY 11550

Committee on Continuing Legal Education
Bernard M. Eiber
55 Northern Boulevard, Suite 302
Great Neck, NY 11021

Committee on Elder Law
Dean S. Bress
399 Knollwood Road, Suite 107
White Plains, NY 10603

Committee on Family Law
Frank G. D'Angelo
999 Franklin Avenue, Suite 100
Garden City, NY 11530

Committee on Immigration Law
David W. Meyers
1734 Western Avenue
Albany, NY 12203

Committee on Labor and Employment Law
Betty M. Semel
100 Park Avenue, 12th Floor
New York, NY 10017

Committee on Law Office Economics & Management
Charles W. Shorter
111 Marshall Road Spur
P.O. Box 847
Norwich, NY 13815

Committee on Litigation
James P. O'Brien
20 Hawley Street
P.O. Box 2039
Binghamton, NY 13902

Committee on Member Relations
Dwayne Weissman
2171 Jericho Turnpike, Suite 212
Commack, NY 11725

Committee on Nominating
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Committee on Professional Issues & Standards
Frank R. Rosiny
225 Broadway, 40th Floor
New York, NY 10007

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Steven L. Kessler
60 East 42nd Street, Suite 1136
New York, NY 10165

Committee on Real Estate Practice
Charles B. Rosenstein
7 Airport Park Boulevard
Latham, NY 12110

Committee on Trusts and Estates Law
Lynne S. Hilowitz
120 North Main Street, 4th Floor
New City, NY 10956

Committee on Workers' Compensation
Martin Minkowitz
180 Maiden Lane
New York, NY 10038

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General Practice, Solo & Small Firm Section
New York State Bar Association
One Elk Street
Albany, NY 12207-1002

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