THE LAWYER'S DAILY

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**Tax**

# Tax treatments of sole proprietorships and associations

By **David Rotfleisch**

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(September 20, 2017, 10:14 AM EDT) -- The choice of business structure for any venture affects how the owners are taxed. This is as true for lawyers as for any other entrepreneur or professional; different law firm structures have different tax treatments. Furthermore, if a lawyer does not like the tax treatment of their current structure, a reorganization on a tax-free basis is usually possible.

This article outlines the taxation of different types of law firm structures. Part one of this three-part series will address the traditional sole proprietorship and association. Part two will look at general partnerships arrangements and limited liability partnerships. In part three, I will discuss professional corporations and reorganizations to change operating structures.

**Lawyer sole proprietorship**

The simplest and oldest structure for a law firm is a sole proprietorship. It is easy to set up, requiring minimal formalities and can grow to accommodate employees. However, except in an early startup scenario, it has less tax advantages than other forms of operation. It also has to evolve if employees are to be brought into the business as partners.

A sole proprietorship has to have a calendar year-end. This means that the tax benefit from a non-calendar year-end is not available. A proprietorship is in law really just the owner with a business name and is not a separate legal entity. The individual/proprietor will prepare the financial statements for Dec. 31 of each year.

Changes announced in the last federal budget in March 2017 mean that unbilled work in progress (WIP) has to be valued and included in income of the proprietorship. Expenses, including depreciation (CCA, in tax parlance) are deducted from that gross income and the resulting net income will be shown on the annual T1 tax return, on form T2125. Since a sole proprietorship lawyer is a self employed individual, that return is due on June 15, rather than April 30, but taxes owing have to be paid by April 30.

Since the proprietorship is not a separate legal entity, there is no real concept of owner draws. While a separate general account is not mandated by the Law Society of Upper Canada in the case of sole proprietorships in Ontario, it is highly recommended by them and it is in fact folly to operate a practice out of a personal bank account. So, while there will be withdrawals from the general account into a personal account, those withdrawals have no tax implications. Similarly, if you pay personal expenses out of your general account, you will incur unneeded accounting or bookkeeping fees in removing those expenditures from your income statement, but there are no adverse tax consequences to these transactions.

**Legal association**

An association is really a variant of a sole proprietorship for multiple lawyers each of whom practises as a proprietor, but enjoys synergies of staff and share expenses. While the financial arrangements may entail separate or joint general accounts, the accounting is similar to that of a proprietorship with the added allocation of joint expenses.

The tax treatment of the association is the same as that of the proprietorship. It will have a calendar year-end. All associated lawyers prepare their own financial statements and file a personal tax return by June 15. Again, there are no tax implications to taking draws out of a common or separate general account. All income is taxable when earned and is not affected by taking funds out of, or leaving funds in a law firm bank account.

This is part one of a three-part series.

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