

# Legal Structure of Architecture Firms

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## SUMMARY

An architecture firm's legal structure is regulated by state laws. Generally, a firm may select the legal structure that best meets its business needs, but some states restrict the type of legal structure that a firm can assume. As licensed professionals, architects cannot rely on a firm's legal structure to protect them from professional liability. Legal counsel can help a firm's owners determine what legal structure (i.e., a sole proprietorship, a corporation, a subchapter S corporation, a professional corporation, a limited liability company, or a limited liability partnership) will best meet the firm's needs.

## CONSULT YOUR ATTORNEY

The information herein should not be regarded as a substitute for legal advice. Readers are strongly advised to consult an attorney for advice regarding any matter related to the legal structure of architecture firms.

## THE RANGE (AND LIMIT) OF POSSIBILITIES

In most states, business owners may conduct business under many legal forms of organization, though some forms, such as a professional corporation, may be permitted only for certain types of businesses.

Some states may restrict the type of legal structure under which architecture firms may conduct business. In some states, for example, architecture firms cannot operate as general business corporations. Such restrictions may be intended to make architects' professional liability as transparent to the public as possible or to ensure that only licensed architects own and control architecture firms.

Other states may rely on professional licensure acts to protect the public interest regarding professional liability and oversight and may be less restrictive regarding the legal structure of architecture firms.

## LEGAL STRUCTURE AND PROFESSIONAL LIABILITY

As licensed professionals, architects are personally liable for their professional acts. They may transfer some of the risk of professional liability to an insurer, but they may not transfer or otherwise assign the liability itself to any other party, including a corporate entity. The legal structure of an architecture firm cannot be counted upon to shield an architect from professional liability. However, certain forms of legal structure—including corporations, professional corporations, or limited liability companies (LLCs)—may limit the personal exposure of an architecture firm's owners to other risks for which business entities are generally held responsible, such as employment practices or general business liability. If the desire to minimize personal risk is a principal factor in the selection of the legal structure for a firm, it is advisable to consult legal counsel to determine whether the legal structure chosen will provide the desired reduction in personal risk.

## LEGAL STRUCTURE ACROSS STATE LINES

Generally, the state laws that regulate the legal structure of businesses apply to all businesses operating in that state, including businesses lawfully organized in another state. Because restrictions vary from state to state, the organizational structure of an architecture firm might be legal in one state and illegal in another, even if the individual architects in the firm are properly registered in both states.

The lack of a physical presence in a state generally does not relieve architects of their legal obligations with respect to the legal structure of their firms. Any firm conducting business in a state generally must comply with the laws of that state whether or not the firm maintains an office there.

It is advisable for an architecture firm to consult legal counsel to determine whether the firm is in compliance with the laws governing the legal structure of architecture firms in all states in which the firm conducts business.

## THE MENU OF OPTIONS

State-by-state restrictions notwithstanding, architecture firms are generally free to choose from many legal forms of organization. The advantages and disadvantages of each should be weighed to determine which form of organization is most suitable for a particular firm. The legal structure generally is of greatest concern when a firm is initially formed, but it should be reexamined as a firm grows and changes to ensure that it continues to suit and support the firm’s strategic business objectives.

### Sole Proprietorship

A sole proprietor is an individual conducting business as an unincorporated entity. Legally, the individual and the business are indistinguishable from one another. All business revenues and expenses (including wages paid to employees, if any) are treated as the personal revenue and expenses of the proprietor. This is the simplest form of organization for an architect starting a business because it typically requires no creation papers or additional tax returns to be filed. Some states, counties, or municipalities may require registration of unincorporated businesses, but generally this may be done by completing a simple form and paying a minimal filing fee, if any.

While it is generally not required by law, sole proprietors are strongly advised to maintain a clear distinction between their personal and business finances. The tax implications of business expenses are different (and often, more favorable) than personal expenses. Lending authorities may require a sole proprietor to provide a clear and distinct picture of business activity as a condition of approval for a line of credit or a loan. Separate bank accounts and financial accounting systems for the business make it easier for a sole proprietor to document business revenue and expenses for tax or borrowing purposes.

The principal disadvantage of a sole proprietorship is that generally the proprietor may be personally at risk of general business liabilities. If a client slips and falls on the proprietor’s icy walk or an employee alleges illegal employment practices, the sole proprietor’s personal assets, which “the corporate veil” might otherwise protect, may be at risk.

### Partnership

Like a sole proprietorship, a partnership is an unincorporated business that traditionally has been legally indistinguishable from the partners. However, because ambiguities, assumptions, or differences in understanding among partners sometimes lead to

legal disputes, many states have enacted “partnership acts” or statutes that establish basic legal principles to govern the relationship among partners and the business relationships between the partnership and other parties. In most states, most of the provisions of such statutes apply unless the partners have a written partnership agreement that establishes specific (and differing) terms. Some provisions of state partnership acts, however, may apply regardless of the terms of a written partnership agreement. When forming a partnership, it is advisable to consult legal counsel to determine the provisions of applicable law.

A written partnership agreement is advisable whether or not a partnership act is in force in the state in which the partnership is formed. In some cases, an agreement is advisable *because* a partnership act exists. Some state partnership acts assume, in the absence of a partnership agreement, that the partners invest equal amounts of capital, share income and losses equally, and contribute equal amounts of time and effort. Some partnership acts might not recognize time and effort as having monetary value, so if two partners agree that one partner will invest more money while the other partner will invest more time and effort, the judgment in a legal dispute might not recognize the value of the time and effort unless the partnership agreement addresses it specifically and explicitly.

Among the issues that a partnership agreement should address are the following:

- Initial investment of each partner
- Distribution of profits and allocation of responsibility for losses among the partners
- Fiduciary duties of the partners—how additional investments, if needed, will be made, by whom, and in what proportion
- Management and operational structure of the firm, including each partner’s decision-making responsibilities and authority
- Expectations for each partner
- Dispute resolution mechanisms
- Admission of new partners
- Departure of existing partners, including provisions in the event of a partner’s death, divorce, or incapacity
- Terms of dissolution, liquidation, or sale of the partnership

Partnerships must file a federal tax return (called an “information return”) but do not pay federal income

taxes. Instead, the partnership's tax return includes a schedule that enumerates each partner's share of the profits or losses. The partners must then transfer that information to their respective personal tax returns and pay any taxes due on their individual share of the profits. State and local governments that require the payment of income taxes may have different filing and tax payment requirements.

Like sole proprietors, the partners in an unincorporated partnership may be personally at risk for general business liabilities. In addition, partners are generally "jointly and severally liable" for the full financial obligations of the partnership, regardless of each partner's share of financial interest in the firm.

### **Corporations**

The principal advantage of a corporate legal structure is that, unlike a proprietorship or a partnership, the personal assets of the shareholders generally cannot be reached to satisfy the liabilities or obligations of the company.

General business corporations are separate and distinct legal entities that may be formed for any legal purpose and that are often recognized as having many of the rights and obligations of "persons" before the law. Certain legal requirements must be met to establish and maintain a corporation, but because its legal existence is independent of the individuals who own or manage it, a corporation is likely to be more durable than a proprietorship or partnership.

Business corporations are owned by shareholders or stockholders, who elect a board of directors to govern the corporation. The ownership interest of each shareholder is defined by the number of shares or stock certificates that each shareholder owns in relation to the total outstanding shares. The founders establish the initial distribution of shares at the time of incorporation. The distribution of shares thereafter occurs in accordance with the corporation's bylaws and applicable law.

The shares of publicly held corporations are bought and sold on the open market. Shares of privately held companies, such as architecture firms, are often bought, sold, or exchanged privately among interested parties. However shares of a corporation are bought or sold, the independent legal status of a corporation may allow the value of the business to be measured with greater clarity and precision, while the liquidity of corporate stock may allow ownership to be transferred more easily and with less ambiguity than in a partnership. These are among the reasons

that the owners of an architecture firm might organize the firm as a corporation.

As independent legal entities, corporations must maintain separate financial records and file separate tax returns. The principal shareholders of privately held companies are often (but not always) involved in the day-to-day management and operation of the business. Such individuals are usually employees of the corporation and usually receive salaries, from which taxes are withheld as for any other employee. In this way, the compensation of shareholder employees can be established on the basis of their skill, experience, expertise, and work effort, while their share of the profit or loss is determined separately by their share of ownership in the corporation. Because both the corporation and the shareholder employees must pay income tax, the shareholders or directors of privately held companies often may choose to distribute profits to shareholders as bonuses to reduce the likelihood of "double taxation."

### **Subchapter S Corporation**

"S-Corps," as they are often called, are general business corporations whose owners have elected to comply with the provisions of Subchapter S of the U.S. Internal Revenue Code. This election allows corporations to treat corporate income (profits), for federal tax purposes, as an unincorporated partnership would treat them. In other words, the corporate profits and losses are "passed through" to the shareholders in proportion to their share of ownership. In most cases, the corporation itself pays little or no federal income tax. The owners of S-Corps can thus enjoy the protection of their personal assets afforded by "the corporate veil" while mitigating or even eliminating the risk of double taxation. Note, however, that as with general business corporations, S-Corps do not protect licensed professionals from professional liability, and that the state income tax implications of S-Corp status may vary from state to state.

### **Professional Corporations**

The liability of shareholders in a general business corporation is ordinarily limited to their share of ownership in the company. Because this legal principle might conflict with the principle of professional liability, some states may allow or may even require professionals licensed by the state, including doctors, lawyers, architects, and engineers, to organize their businesses as professional corporations.

Professional corporation statutes typically include provisions explicitly stating that corporations formed under the statute do not relieve the shareholders of professional liability. They also generally set ownership restrictions to ensure that licensed professionals own, or at least control, the business. Professional corporations usually are required to include the initials “P.C.” in the corporate name to publicly distinguish them from general business corporations.

The tax liability of professional corporations is generally the same as for general business corporations, though in some states they may be subject (or entitled) to special tax considerations. A professional corporation also may be eligible for Subchapter S status.

### Limited Liability Companies or Partnerships

Several states have enacted laws that permit certain types of businesses to be organized as limited liability companies (LLCs) or limited liability partnerships (LLPs). An LLC or LLP is a distinct legal entity that usually combines the limited liability protection of a corporation with the profit/loss pass-through tax features of a partnership or Subchapter S corporation. LLCs or LLPs also are generally allowed more flexibility than general business or professional corporations in terms of management structure, which the shareholders may find advantageous.

Some states do not allow architecture firms to organize as limited liability companies or partnerships, while others have statutes that permit the formation of *professional* limited liability companies (PLLCs) or partnerships (PLLPs).

### HOW TO CHOOSE?

At first glance, there seems to be little difference between an S-Corp, a professional corporation, and an LLC or LLP. The principal factors in choosing a corporate form of organization are likely to include how state and local authorities will treat the company for tax purposes and how the company plans to grow or change ownership over time.

## RESOURCES

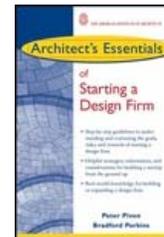
### More Best Practices

The following AIA Best Practices provide additional information related to this topic:

- 06.07.01 Multistate Practice: Certificates of Authority
- 06.08.02 Essential Elements of Ownership Transition
- 06.06.04 Seven Tips for Emerging Firms

### For More Information on This Topic

This article is excerpted and adapted, in part, from *Architect's Essentials of Starting a Design Firm*, by Peter Piven, FAIA, and Bradford Perkins, FAIA. Written by two leading experts in the field, this valuable resource addresses all aspects of starting and maintaining a successful design firm.



Portions of this article also have been excerpted and adapted from “Firm Legal Structure” by Philip R.

Croessmann, AIA, *The Architect's Handbook of Professional Practice*, 13th edition, Chapter 6, page 123. Both books can be ordered from the AIA Bookstore by calling 800-242-3837 (option 4) or by sending e-mail to [bookstore@aia.org](mailto:bookstore@aia.org).



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### Keywords

- Practice
- Business planning
- Business structures