

MEMORANDUM TO: DAN SWEETWOOD, BOARD OF PUBLIC ACCOUNTANCY

FROM: JOHN GALE, SECRETARY OF STATE

December 9, 2011

RE: Conversion of Business Corporations Owned by Licensed Professionals from Business Corporations to Professional Corporations or Professional Limited Liability Companies – Possible Tax Consequences to be considered

The State of Nebraska adopted the Nebraska Professional Corporation Act in 1969, and adopted the Limited Liability Company (LLC) Act in 1993. Both acts allow certain professional licensees to form corporate or limited liability company (LLC) entities that differ from regular business corporations or regular limited liability companies. Those two acts will together be referred to as the “two professional organization acts” or “the two acts” and the entities they deal with will be called “professional organizations”. Those two acts specifically identified certain licensed professionals under their coverage including personal services rendered by a certified public accountant, dentist, osteopathic physician, physician and surgeon, veterinarian, real estate broker, associate real estate broker, real estate salesperson, or attorney at law. For purposes of the two acts, those professions pertaining to the diagnosis, care, and treatment of humans are considered to be of the same profession.

Through my role as the filing officer for business entities and as chair of the Nebraska Real Estate Commission, I have discovered that requirements of these two acts may not be universally understood or followed. The purpose of this memorandum is to provide some background on recent changes to the business entity organization laws and to promote compliance with those provisions.

The two professional organization acts allowed those licensed professionals to gain certain advantages of a corporate structure or an LLC structure, but subject to the conditions of the

two acts including the renewal of the entity each year by filing the needed certificates of current licensing by the owners with the Secretary of State.

The licensed professionals identified under the two professional organization acts were deemed to be on notice of the new laws, and faithful compliance would be assumed. However, in 2011, it became clear that there wasn't full compliance. A "designated real estate broker" is a licensee, who by law is responsible for the real estate activity of the brokerage firm. Even after the adoption of the two acts, designated real estate brokers in a number of instances across the state were incorporating as regular business corporations. The reasons were various, including a need for outside non-professional stockholders. As of January, 2011, it appeared that there were a sufficient number of such business corporations in existence for designated brokers that the question became whether to exempt them or to require them to come into compliance. Certain interested parties at that time sought to have the legislature exempt all "real estate licensees" from the two professional organization acts. Upon further investigation, it was discovered that a number of "real estate associate brokers" and "real estate salespersons", had also created regular business corporations to handle their professional business dealings rather than creating a professional organization.

There are some 7,000 "real estate licensees" in Nebraska. Designated brokers constitute only about 5% of all real estate licensees, and are licensed individuals who operate their own real estate business. The businesses range in size and scope from sole proprietorships with no employees to entities such as Home Services of America, Inc., a large business corporation owned by Berkshire-Hathaway. All other real estate licensees, salespersons and associate brokers, may only conduct business under the supervision of their designated broker.

Under the legislation as originally proposed, the entire real estate profession would have been exempted from the restrictions of the two professional organization acts. The Secretary of State took the position that such special legislation benefiting only a single licensed profession named in the Professional Corporations Act with an exemption could be suspect; that it could

be unfair to the other named licensed professions which had been complying with the law; that disregarding the constraints of the corporation and limited liability company laws in order to gain possible tax advantages with the IRS was not a justification under the law; that such entities covering licensed professionals in a manner contrary to state law might subject the entities to federal IRS scrutiny; that the reasons offered to exempt all real estate licensees seemed to be unfounded.

A legislative compromise was reached which exempted “designated real estate brokers” from both of the two professional organization acts, but did not exempt the associate brokers and salespersons. The Secretary of State then adopted a policy that such associate brokers and salespersons who were incorporated as business corporations contrary to the business entity laws would have a grace period until January 1, 2012 to amend their articles to convert to either a corporate or an LLC professional organization or to create an entirely new entity that would be in compliance. Any fees that would have been due to the Secretary of State for non-compliance in past years would be waived if compliance was completed by January 1, 2012, and filing fees for the amended articles properly paid.

Obviously, there might be tax consequences to the conversion of a business corporation to a professional organization by the simple act of amending articles of incorporation. It may depend upon the past treatment of “earned professional income” under the federal tax laws. If a business corporation was also a Subchapter S corporation before conversion, that might be another issue needing review by an accountant. In either case, the existing entity has an Employer Identification Number (EIN) with the Internal Revenue Service; that may or may not need to be changed. The tax status of the newly converted entity might be treated differently than the former business corporation. If licensed associate brokers or real estate salespersons had been organized as regular corporations and had regularly held back portions of earned professional income from taxation until later years, that could be an issue. Converting limited liability companies to professional limited liability companies might be a simpler matter; a charter amendment may well be all that is necessary without changing the EIN.

After the grace period of the Secretary of State ends, regular business corporations or LLCs providing professional services requiring a real estate license (other than “designated real estate brokers”) may be subject to disciplinary action by the Nebraska Real Estate Commission or may be reported to the Nebraska Attorney General as being in violation of the two professional organization acts. They may also become subject to possible actions to dissolve their non-compliant entities.

In all events, the advice of a licensed professional attorney or a certified public accountant is strongly advised so that the action taken to comply with the company formation laws of the state does not end up causing unexpected tax consequences which might have been avoided.