South Carolina Law Review

Volume 17 | Issue 2 Article 2

1964

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Recommended Citation

Bluestein, Joseph S. (1964) "Tax Considerations of Professional Associations," *South Carolina Law Review*: Vol. 17 : Iss. 2 , Article 2.

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TAX CONSIDERATIONS OF PROFESSIONAL ASSOCIATIONS[1]

JOSEPH S. BLUESTEIN*

Tax savings is perhaps the essential consideration in any business plan. Typical of this fact is the move on the part of professional people in the last several decades to avail themselves of the benefits of doing business or providing services in the corporate form. The professional association is a direct result of this tendency. Since 1961 an astounding number of states[2] have enacted statutes which permit professional people to incorporate. Prior to the statutes, the professions had relied on the Internal Revenue Code definition of a corporation as an association.[3] However, the Commissioner of Internal Revenue, foreseeing the tendency towards taxability as an association, began to place emphasis on local law which in most cases prevented professionals from incorporating. In an effort to assist the professions, the states very speedily began to enact professional association statutes giving the professional corporation the recognition of local law. The professional association is basically a corporation, but it does retain some of the characteristics of a partnership. This appears to be the principal reason the Commissioner of Internal Revenue has sought to challenge the taxation of professional people as a corporation. The primary purpose of this article is to define the tax considerations involved in determining whether or not a professional person should incorporate. There are also some very important non-tax considerations, and they will, at least, be mentioned.[4]

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1. They are also commonly referred to as professional corporations and professional service corporations. The South Carolina Code §§ 56-1601 through 56-1617 (Supp. 1964) makes reference to professional associations.

2. Exactly thirty-two states, including South Carolina, have enacted such statutes and one state, Colorado, has judicially held that professionals may incorporate. The majority of these statutes, including that of South Carolina, allow all professions to incorporate while several limit incorporation to particular professions such as medicine or law.

3. INT. REV. CODE OF 1954, § 7701(a)(3) and Treas. Reg. § 301.7701-2 (1960).

4. The following material contains a discussion of the professional association and its tax and non-tax aspects: *Panel: Professional Associations,* 101 TRUSTS & ESTATES 886 (1962); *Professional Corporations and Associations,* 75 HARV. L. REV. 756 (1962); *Professional Corporations: A New Trend?,* 43 B. U. L. REV. 107 (1963); Alexander, *Some Tax Problems of a Professional Association,* 13 W. RES. L. REV. 195 (1962); Buchmann and Bearden, *The Professional Service Corporation—A New Business Entity,* 16 U. MIAMI L.

Published by Scholar Commons, 2020

Background and Development

Essential to any discussion of the professional association is an understanding of the nature of this entity and the events which led to its creation. Its history begins ironically with an attempt on the part of the Commissioner of Internal Revenue to tax a trust as a corporation in order to enact upon the trust the burdensome incidents of corporate taxation. In *Morrissey v. Commissioner*[5] the United States Supreme Court held that a trust established for the development of real estate was taxable as an association since its major characteristics were corporate. The Court specifically pointed to the fact that the trust had been created for profit-making purposes and "the arrangement provided for centralized control, continuity, and limited liability."[6] Furthermore, there was a provision for the issuance of transferable certificates. The Commissioner's position in this case was based on a definition in the Internal Revenue Acts of 1924 and 1926 that "the term 'corporation' includes associations, joint-stock companies, and insurance companies." The definition in the present Internal Revenue Code is identical.[7] The holding of the *Morrissey* case was substantiated in *Pelton v. Commissioner*[8] where the court held that a medical clinic operated for profit under an agreement between physicians, who were made trustees, to divide their interests into transferable shares to ex-

REV. 1 (1961); DAVIES & LAWRENCE, CHOOSING A FORM OF BUSINESS ORGANIZATION, 122-143 (1963) (prepared by Duke University, April, 1963); Deering, *Incorporation by Attorneys*, 42 ORE. L. REV. 93 (1963); Eaton and Maycock, *Professional Corporations: Tax Benefits are not Lost in Today's New Hostile Climate*, 20 J. TAXATION 150 (1964); Eaton and Maycock, *Proposed Kintner Regs Arouse Many Protests as Being Inequitable and Discriminatory*, 20 J. TAXATION 222 (1964); Eber, *The Pros and Cons of the New Professional Service Corporations*, 15 J. TAXATION 308 (1961); Eber, *Professional Service Corporations*, 103 TRUSTS & ESTATES 420 (1964); Goldberg, *Professional Corporations—Current Status*, 19 BUS. LAW. 707 (1964); Haddleton, *Kintner Regs Now Block Professional Corporations; Final H.R. 10 Rules Analyzed*, 20 J. TAXATION 74 (1964); Joyner, Pemberton and Taylor, *The Tax Dilemma of the Self-Employed Professional*, 28 MO. L. REV. 161 (1963); Mackay, *Pension Plans and Associations Taxable as Corporations for Professional Persons*, 10 SWL.J. 281 (1956); Maier, *Professional Corporations and Kintner Associations Advancing; Box Score to Date*, 17 J. TAXATION 2 (1962); Pesin, *Professional Associations Doing Business as Corporations*, 21 N.Y.U. TAX INST. 565 (1963); Ray, *A Comparison of Tax Benefits Available Under H.R. 10 With Those Provided by Professional Associations*, 26 GA. B.J. 269 (1964); Sarner, *Associations Taxable as Corporations: A Review and Look Ahead*, 20 N.Y.U. TAX INST. 609 (1962); Thrower and Cohen, *Professional Associations Under Georgia Act—Some Tax Aspects and Considerations of Legal Ethics*, 24 GA. B.J. 163 (1961).

5. 296 U.S. 344 (1935).
6. *Id.* at 360.
7. INT. REV. CODE OF 1954 § 7701 (a) (3).
8. 82 F.2d 473 (7th Cir. 1936).

empt themselves from personal liability and to maintain some centralized management, was to be taxed as an association and not as a trust or partnership. The *Pelton* court had rendered its decision notwithstanding the fact that under the applicable state law a corporation could not practice medicine. Apparently, all the court found necessary in order for the trust to be taxed as an association was that it fall within the Internal Revenue Code definition of association.

The case of *Kintner v. United States*[9] marks the beginning of the taxpayer's attempt to utilize the *Morrissey* case to his benefit. The facts involved a group of doctors who dissolved their partnership and transferred the assets to a medical clinic. The articles of association provided that the members were to be associated for the practice of medicine as an unincorporated association endowed with the "attributes of a corporation" and to be "treated as a corporation for the purposes of taxation." The court held that based on the Commissioner of Internal Revenue's own regulations, which were merely a restatement of the *Morrissey* and *Pelton* cases, the medical clinic was to be taxed as an association since it more closely resembled a corporation than a partnership. It was found that while the articles of association disclaimed the liability of one doctor for the negligence of another, the medical association which contracted with the patient and received his fees would be responsible to the patient. The liability of the association as an entity was a significant element in distinguishing it from a partnership. The Internal Revenue Service at first announced that it would not follow the *Kintner* case[10] since the doctors, who had attempted to establish a qualified corporate pension plan under Section 401 (a) of the 1954 Code, were not employees within the meaning of this section:[11] but it thereafter announced that it was modifying its position, and that merely because an association establishes a pension plan under Section 401 (a) "is not determinative of whether such organizations will be classified as a partnership or an association taxable as a corporation." It was further stated that "the usual tests would be applied to determine whether a particular organization of doctors or other professional groups has more characteristics of a corporation than of a partnership."[12]

9. 216 F.2d 418 (9th Cir. 1954).
10. Rev. Rul. 56-23, 1956-1 Cum. Bull. 598.
11. Rev. Rul. 33, Part 2 (a) (1), 1953-1 Cum. Bull. 267 at 269.
12. Rev. Rul. 57-546, 1957-2 Cum. Bull. 886.

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In the meantime, a group of doctors in Texas formed the Southwest Clinic Association for the purpose of being taxed as a corporation. In *Galt v. United States*,[13] it was held that even though a medical clinic could not be incorporated under Texas law, for purposes of federal taxation the clinic was to be treated as a corporation.

Finally, in Treasury Regulations 301.7701-1 and -2 (1960), commonly referred to as the "Kintner Regulations," the Commissioner established the Internal Revenue Service's position. Therein, the term "association" is not defined in a narrow sense but applies to all organizations which possess more corporate than non-corporate characteristics. The characteristics to be considered are continuity of life, centralization of management, limited liability and free transferability of interests.[14] As an example of an organization which would be classified as an association for purposes of the Internal Revenue Code the facts of the *Galt* case are given.[15] With regard to the effect of local law, the Treasury Regulations state that it is the Internal Revenue Code which determines the standards to which the organization must conform in order to be taxed as an association and not the law of a particular state: but it is state law that is to determine the legal relationships established and whether these relationships meet the Internal Revenue Code standards.[16] These Regulations, therefore, placed considerably more emphasis on local law than the *Kintner* and *Galt* cases had done. In fact, those states which had adopted the Uniform Partnership Act, found it seemingly impossible[17] for an organization to qualify under the Regulations. For example, the Uniform Partnership Act, as enacted in South Carolina, provides for dissolution upon the termination of any partner's interest.[18] It also provides for the liability of each partner for the partnership debts.[19]

13. 175 F. Supp. 360 (N.D. Tex. 1959).

14. For an excellent discussion of these characteristics see Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments,* 17 TAX L. REV. 1,8 (1961) and Grayck, *Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments,* 17 TAX L. REV. 469, 473 (1962).

15. Treas. Reg. 301. 7701-2 (g), example 1 (1960).

16. For example, if an association agreement provided that the organization was to last in perpetuity but under local law any member has the power to dissolve the organization, the organization would lack continuity of life.

17. This fact is disputed in Maier, *Professional Corporations and Kintner Associations Advancing; Box Score to Date,* 17 J. TAXATION 2,5 (1962).

18. S.C. CODE ANN. § 52-61 (1962).

19. S.C. CODE ANN. § 52-27 (1962).

The "Kintner Regulations" left only one choice for those professionals desiring to be taxed as corporations—convince their states to legislate for professional corporations and associations. Beginning in March, 1961, the states did just that. Generally, the statutes enacted permit professional people to incorporate or form associations outside of the provisions of the Uniform Partnership Act in order that they may meet the requirements of the "Kintner Regulations."

The Internal Revenue Service has yet to rule on a situation in which an organization has been established under a professional association act. However, in December 1963, the Internal Revenue Service did announce proposed amendments to the "Kintner Regulations."[20] The proposed Treasury Regulations provide that an organization will not be taxed as an association merely because it is labeled a professional corporation or association under state law. The organization must meet the tests established in the Treasury Regulations.[21] Furthermore, the proposed Treasury Regulations discuss each of the characteristics needed to qualify the professional association concluding that it will be difficult for an association to qualify. The proposed Treasury Regulations also delete example number one of the Kintner Regulations without any explanation. These Regulations are still in the proposal stage; however, the Internal Revenue Service can be expected to act upon them soon.

It should be noted that in March 1964, a Florida district court in the case of *Foreman v. United States*[22] reaffirmed the decisions in *Galt* and *Kintner*. However, this case did not involve an organization created under one of the professional association statutes.

Since the professional association is a departure from the normal form of practicing a profession, whether it be medicine, law or accounting, there are certain ethical considerations involved. In Opinion 303 of the American Bar Association Professional Ethics Committee,[23] it was said that it is not the form of the organization used to practice law which determines its ethical propriety, but it is the substance of the arrangement which is controlling. It appears this committee would sanction the professional association, provided certain safeguards were

20. Federal Register, December 17, 1963.
21. Treas. Reg. §§ 301.7701-2, 301.7701-3 and 301.7701-4 (1960).
22. 232 F.Supp. 134 (S.D.Fla. 1964).
23. Adopted November 27, 1961.

taken, such as the personal responsibility of the lawyer performing the legal services[24] and the transferability of the lawyer's interest, upon death or otherwise, only to lawyers.[25] The Code of Ethics of the American Institute of Certified Public Accountants[26] prohibits any member or associate from being a shareholder in any corporation engaged in the practice of public accounting. On the other hand, the American Medical Association has approved the practice of medicine in the corporate form, as long as licensed physicians retain the ownership and management.

The South Carolina Code, Section 56-142 (1962), adopted in 1946, provides that it shall be unlawful for a corporation or voluntary association to practice law. This section would appear to be inconsistent with the 1962 Professional Association Act of South Carolina[26a] which permits an association to be organized for the purpose of carrying on a profession. If so, it is a settled principle that the more recent of two conflicting statutes will govern.[27]

Tax Advantages and Disadvantages

The first question which comes to the professional man's mind upon learning of the professional association is whether he will

24. S.C. CODE ANN. § 56-1607 (Supp. 1964) provides: "This chapter does not modify any law applicable to the relationship between a person furnishing professional service and a person receiving such service, including liability arising out of the professional service, and including the confidential relationship between the person rendering the professional service and the person receiving the professional service, and all confidential relationships previously enjoyed under the laws of this State or hereinafter enacted shall remain inviolate. Subject to the foregoing provisions of this section, the members or shareholders of any professional association organized pursuant to the provisions of this chapter shall not be individually liable for the debts of, or claims against, the professional association unless such member or shareholder has personally participated in the transaction for which the debt or claim is made or out of which it arises."

25. S.C. CODE ANN. § 56-1610 (Supp. 1964) provides: ". . . . A professional association may issue its capital stock if it is a stock-type association, if it is a nonstock association, only persons who are duly licensed or otherwise legally authorized to render the same professional service as that for which the professional association was organized. Subject to the provisions of the articles of association, the estate of a member or shareholder who was a person duly licensed or otherwise legally authorized to render the same professional service as that for which the professional association was organized may continue to hold stock or membership pursuant to the articles of association for a reasonable time during the administration of the estate, but shall not be authorized to participate in any decision concerning the rendering of professional service." The last sentence of this section would probably not violate the Committee opinion that a member's interest not fall into the hands of a non-lawyer since the estate is not holding the stock "on a permanent beneficial and voting basis."

26. Art. IV, Rule 4.06.

26a. S.C. CODE ANN. § 56-1601 to -1617 (Supp. 1964).

27. 82 C.J.S. *Statutes* § 291 (1953).

derive any tax benefits by doing business as an association. This will, of course, depend on the individual's particular situation. Basically, the advantages and disadvantages of a professional association are the same as those for any corporation. But perhaps it would be worthwhile to consider these advantages and disadvantages in the light of a typical professional partnership in South Carolina: that is, the six or eight member law firm, accounting firm or medical clinic.

1. Retirement Plans

The primary advantage of the professional association is the corporate retirement plan. Without this advantage, the association would be of very little benefit. Prior to 1962, taxation as an association provided much more tax savings than it does today, since there was no tax-oriented retirement plan for the self-employed professional.[28] However, the enactment of the Self-Employed Individuals Tax Retirement Act of 1962,[29] commonly known as the Keogh Bill or H.R. 10, has given the professional an opportunity to establish a retirement plan. The present choice is that of either remaining as a professional partnership and obtaining only some of the tax benefits of a corporate retirement plan under H.R. 10 or of organizing under a professional association act and obtaining all of the benefits of a corporate plan.[30]

H.R. 10 permits the self-employed to make contributions to a retirement plan in the amount of ten per cent of earned income or $2,500, whichever is less,[31] and to deduct as an expense one-half of the annual contribution made for him, but in no event more than five per cent of his earned income or $1,250, whichever is less.[32] By comparison, the corporate pension plan permits

28. This statement may be disputed by some but 17 ABA BULL. OF SECTION OF TAXATION, pt. I at 47 (1963) illustrates that H.R. 10 does provide a tax savings.

29. Pub. L. No. 87-792, 76 Stat. 809 (1962).

30. For an extensive and detailed treatment of H.R. 10 as compared with the qualified corporate plan, see Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-employed Individuals Tax Retirement Act of 1962 and the Professional Association*, 63 COLUM. L. REV. 415 (1963); ABA, SECT. OF REAL PROP., PROBATE & TRUST LAW, Pt. I at 135 (1963); 17 ABA BULL. OF SECT. OF TAXATION, Pt. I, at 41 (1963); Ray, *A Comparison of Tax Benefits Available Under H.R. 10 with those provided by Professional Associations*, 26 GA. B.J. 269 (1964); Joyner, Pemberton and Taylor, *The Tax Dilemma of the Self-employed Professional*, 28 MO. L. REV. 161, 197 (1963).

31. INT. REV. CODE OF 1954, §§401 (d) (5) (A)-(B), 404(e) (1)-(2).

32. INT. REV CODE OF 1954, §§404 (a) (10), (e) (1).

contributions to be made in such amounts as may be necessary to fund the plan,[33] and the entire amount of the contribution is deductible by the corporation.[34] If the corporation is using a profit-sharing plan rather than a pension plan, full deductibility is provided for contributions up to fifteen per cent of the payroll of the covered employees.[35] It is significant to point out that H.R. 10 distinguishes between those partners who own ten per cent of the partnership and those who do not.[36] Those who own a ten per cent interest are called owner-employees. The above limitation as to contributions and their deduction applies only to the owner-employee. Therefore, all partners in the firm or clinic who own less than a ten per cent interest and all employees of the partnership such as secretaries, would be treated as a corporate employee. Suppose law firm *XYZ* sets up a pension plan under H.R. 10 with an annual contribution of ten per cent a year. The firm has net earnings of $100,000 in one year. In accordance with the partnership agreement, partners *X* and *Y* receive $35,000 each, partner *Z* receives $21,000 and partner *V* receives $9,000. Further, suppose the firm has two associates who receive $7,000 each in salaries that year, and three secretaries receiving $4,000 each in salaries. The firm can contribute $2,500 for partners *X* and *Y*, $2,100 for partner *Z* and $900 for partner *V*. It can contribute $700 for each of the associates and $400 for each of the secretaries. A deduction of $1,250 will be allowed for each of the contributions for partners *X* and *Y*, $1,050 can be deducted for partner *Z*'s contribution and $900 for partner *V*'s contribution.[37] Deductions of the full contributions can be taken for the associates and the secretaries. On the other hand, if firm *XYZ* had organized under the Professional Association Act and established a corporate plan, the association could have contributed $3,500 each for partners *X* and *Y*, all of which would have been deductible, and $2,100 for partner *Z*, which would also have been fully deductible.

Another major weakness of H.R. 10 is the coverage that is required under a retirement plan. While the corporate plan does

33. INT. REV. CODE OF 1954, § 404 (a) (1) (A), (B), & (C).
34. INT. REV. CODE OF 1954, § 404 (a).
35. INT. REV. CODE OF 1954, § 404 (a) (3).
36. INT. REV. CODE OF 1954, § 401 (c) (3).
37. Partner *V* is not an owner-employee since he does not own a ten per cent capital interest in the partnership nor a ten per cent interest in the partnership profits. If partner *V* had received $10,000 of the firm profits for that year, he would be an owner-employee and the firm could have deducted only $500 of the $1000 contribution.

not require coverage of all employees,[38] the H.R. 10 arrangement requires that all employees having a period of employment of three years or more must be covered.[39] However, if the corporate plan meets certain percentage requirements imposed by the Internal Revenue Code and/or does not discriminate in favor of higher paid employees, it may exclude hourly-paid workers or employees who have not attained a certain age. But like the corporate plan, H.R. 10 does permit the exclusion of all employees whose customary employment is not more than twenty hours in any one week or is not more than five months in any calendar year.[40] Again a distinction is made between partnerships with an owner-employee or ten per cent partner, and those without such a partner. In the case of the latter, the general rules applicable to coverage under a corporate plan will apply.

The corporate plan does not require that an employee obtain a vested interest in the contributions made for him to the fund and thus the corporation may provide for forfeitures in the case of employees who resign or are discharged prior to their normal retirement.[41] However, the H.R. 10 plan provides that the employee has a vested right in the contributions at the time they are made.[42] This rule does not apply to partnerships which do not have a ten per cent partner. It has been pointed out[43] that the vesting provisions of H.R. 10 would encourage an employee to leave the firm or clinic once he has accumulated some interest under the plan. Distribution of the funds under the H.R. 10 plan to a ten per cent partner can not be made before the employee attains the age of 59½ unless he is permanently disabled.[44] If the ten per cent partner dies before this age, his interest must be distributed within five years or used immediately to purchase an annuity for his beneficiaries.[45] The corporate plan and a H.R. 10 plan where there is no ten per cent partner does not prevent distribution on retirement before age 59½. Under H.R. 10, distribution can be made to a ten per cent partner no later than age 70½, while distribution to a less than ten per cent

38. INT. REV. CODE OF 1954, § 401 (a) (3).
39. INT. REV. CODE OF 1954, § 401 (d) (3).
40. *Ibid.*
41. Rev. Rul. 157, pt. 5 (c), 1961-2 CUM. BULL. 67, 87-88.
42. INT. REV. CODE OF 1954, § 401 (d) (2).
43. Ray, *A Comparison of Tax Benefits Available Under H.R. 10 with those provided by Professional Associations*, 26 GA. B. J. 269, 274 (1964).
44. INT. REV. CODE OF 1954, § 401 (d) (4) (B).
45. INT. REV. CODE OF 1954, § 401 (d) (7).

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partner and a corporate employee may be made at age 70½ or when he retires, whichever is later.[46]

An important advantage of the corporate plan, at least from the viewpoint of the higher paid employees and officers, is that payments to the fund may be integrated with payments to the social security system.[47] That is, payments by the corporation to the social security fund for an employee may permit the corporation to elect not to make any contributions to the retirement trust fund to the extent of such payments. Contributions under an H.R. 10 plan for partnerships with at least one ten per cent partner may be integrated with social security payments if not more than one-third of the employer contributions under the plan are deductible for that year on behalf of the ten per cent partner.[48] In the case of the small firm or clinic, contributions for ten per cent partners will generally run much more than one-third of the total contributions, presenting a problem under H.R. 10.

H.R. 10 is further limited in that it does not provide capital gains treatment for certain lump-sum distributions which the corporate plan does provide.[49] This is a material deficiency of H.R. 10 since any lump-sum distribution to the self-employed, whether or not he is a ten per cent partner, will be taxed at the individual's ordinary income tax rate—with only some relief from the income averaging device[50]—instead of at the capital gains rate of twenty-five per cent.

Distributions from a qualified corporate plan after an employee's death to his beneficiaries other than his executor or estate are exempt from federal estate taxes to the extent attributable to contributions of the employer.[51] H.R. 10 does not make this provision available to the self-employed. In addition, any designation by an employee under a qualified corporate plan, whereby an annuity or other payment will become payable to a beneficiary, is exempt from the gift tax to the extent of employer contributions.[52] This exemption does not apply to the H.R. 10 plan for the self-employed. A $5,000 death benefit exclusion is

46. INT. REV. CODE OF 1954, § 401 (a) (9) (A).
47. INT. REV CODE OF 1954, § 401 (a) (5).
48. INT. REV. CODE OF 1954, § 401 (d) (6) (A); Treas. Reg. § 1.401-12 (h) (1963).
49. INT. REV. CODE OF 1954, § 402 (a) (2).
50. INT. REV. CODE OF 1954, §§ 1301-1305.
51. INT. REV. CODE OF 1954, § 2039 (c).
52. INT. REV. CODE OF 1954, § 2517 (b).

available to the beneficiary or estate of an employee under a qualified corporate plan,[53] but is denied the beneficiary of the self-employed under H.R. 10.[54] Also a sick pay exclusion of $100 per week is made available to an employee who would come within the qualified corporate plan,[55] but it is not made available to an employee under H.R. 10.[56]

2. Insurance

Another advantage of the professional association is that premium payments for group life insurance on the lives of employees would be deductible by the association if the payments are in the nature of additional compensation and if the employer is not directly or indirectly a beneficiary under the policy.[57] Such premium payments are not income to the employee.[58] On the other hand, a partner cannot deduct his share of insurance premiums paid by the partnership.[59] Furthermore, premiums paid by the corporation on health and accident insurance for its employees are deductible by the corporation, if the premiums are reasonable,[60] and the premiums are not includible in the employee's income.[61] A partnership would probably not be able to deduct such premium payments if made for the benefit of the partners.

3. Choice of Fiscal Years and the Estate Planning Aspect

Some minor advantages of incorporation under a professional association act involve a choice of accounting periods and certain estate planning aspects. A corporation has the right to select its own taxable year[62] and need not use the same period as that of its members, while a partnership has the same taxable year as its partners. The advantage is this: if the association chooses a July to June accounting period, the shareholder pays in the year of incorporation, only income tax on its earnings as a partner in

53. INT. REV. CODE OF 1954, § 101 (b) (1).
54. INT. REV. CODE OF 1954, § 101 (b) (3).
55. INT. REV. CODE OF 1954, § 105 (d).
56. INT. REV. CODE OF 1954, § 105 (g).
57. 2 CCH 1965 STAND. FED. TAX REP. ¶ 2223.
58. Treas. Reg. § 1.61-2 (d) (2) (1957), as amended T. D. 6416, 1959-2 CUM. BULL. 126, and T. D. 6696, 1963-2 CUM. BULL. 23.
59. *Supra* note 57.
60. Treas. Reg. § 1.162-10 (a) (1958).
61. INT. REV. CODE OF 1954, § 106.
62. INT. REV. CODE OF 1954, § 441.

the first six months. The earnings of the association for the last six months of that year are not taxed to him until the next year.

Organization as a professional association will also provide greater flexibility in the professional's estate plan. The fact that he owns a readily measurable interest in a legal entity, such as a corporation, facilitates inter vivos transactions, buy-sell agreements and the planability of his estate.

4. Double Taxation and Subchapter S

The professional association does, nevertheless, have its disadvantages. The most important disadvantage is taxation at both the corporate level and at the individual tax level when dividends are distributed to the stockholders. However, if the officers and employees receive all of the corporation's earnings in salaries, there will be no distribution of dividends and no tax at the individual level. But the corporation is limited to a deduction for reasonable salaries and compensation.[63] Any compensation payments which are deemed excessive and are disallowed as a deduction to the corporation will be taxable to the employee.[64] The problem is to determine what is a reasonable compensation.[65] Some of the criteria used to determine whether a salary is reasonable are the employee's qualifications,[66] the nature and extent of services performed,[67] the size of the business,[68] and the amount of compensation paid by like enterprises under like circumstances.[69] It would seem that the attorney, doctor or accountant who receives a salary from his professional association would be within the bounds of reasonable compensation if his salary was comparable to that of non-incorporated professionals or comparable to high level executives in a corporation. However, if reasonable compensation is determined by the nature and extent of services performed, certain semi-active professionals, such as the senior partner in a law firm, might have difficulty justifying their salary. While the senior law partner

63. INT. REV. CODE OF 1954, § 162 (a) (1).

64. Treas. Reg. § 1.162-8 (1958).

65. For cases illustrating the problem see Klamath Medical Serv. Bureau v. Commissioner, 261 F.2d 842 (9th Cir. 1958), *Cert. denied,* 395 U.S. 966 (1959); McClung Hosp., Inc., 19 CCH Tax Ct. Mem. 449 (1960). See also Wolder, *How the Tax Court Treats Reasonable Compensation,* 39 TAXES 473 (1961).

66. See Despatch Oven Co., 4 CCH Tax Ct. Mem. 680 (1945).

67. See Municipal Sec. Co., 4 CCH Tax Ct. Mem. 120 (1945).

68. See H. Levine & Bros. v. Commissioner, 101 F.2d 391 (7th Cir. 1939).

69. Treas. Reg. § 1.162-7 (b) (3) (1958); see also J. D. Van Hoosier & Co. v. Glenn, 50 F. Supp. 279 (W.D. Ky. 1943).

has the important tasks of public relations and perhaps handling of the firm's more involved litigation, his actual time spent in the firm and his copious research of the law will not be as great as that of the junior partners and associates. It is submitted that time and copious research should not be the tests, but actual benefit and value to the firm should be.

To avoid the possibility of being taxed at both the corporate and individual level, the professional association might elect to be taxed as a partnership or individual under Subchapter S.[70] The effect of a Subchapter S election is to tax the association's shareholders on all the earnings of the association, whether or not they are distributed, at their individual tax levels. There is no tax at the corporate level. In order to qualify under Subchapter S, the corporation must be domestic,[71] it must have no more than ten shareholders,[72] it must have as the shareholders only individuals (although an estate may hold shares),[73] it must not have a nonresident alien as a shareholder,[74] and it must have only one class of stock.[75] The larger firms and clinics would have difficulty qualifying. It should be remembered, however, that all doctors, lawyers or accountants in the association do not have to be shareholders. Once the corporation or association has elected to be taxed under Subchapter S the undistributed taxable income[76] is included in the income of each shareholder as if earned on the last day of the taxable year,[77] any net operating loss is allowed as a deduction from a shareholder's gross income[78] and long-term capital gains of the corporation are treated as long-term capital gains to the shareholder.[79] Despite some very obvious advantages of Subchapter S, most of the leading tax writers have not recommended that professional associations make the election.[80] Their basic reason appears to be that

70. INT. REV. CODE OF 1954, §§ 1371-1377. See Lourie, *Subchapter S after Three Years of Operation*, 17 TAX L. REV. 99 (1962).
71. INT. REV. CODE OF 1954, § 1371 (a).
72. INT. REV. CODE OF 1954, § 1371 (a) (1).
73. INT. REV. CODE OF 1954, § 1371 (a) (2).
74. INT. REV. CODE OF 1954, § 1371 (a) (3).
75. INT. REV. CODE OF 1954, § 1371 (a) (4).
76. INT. REV. CODE OF 1954, § 1373 (c).
77. INT. REV. CODE OF 1954, § 1373 (a) and (b).
78. INT. REV. CODE OF 1954, § 1374 (a).
79. INT. REV. CODE OF 1954, § 1375 (a) (1).
80. See Eber, *The Pros and Cons of the New Professional Service Corporations*, 15 J. TAXATION 308, 310 (1961); Deering, *Incorporation by Attorneys*, 42 ORE. L. REV. 93, 129 (1963).

Subchapter S involves too many problems which may be easily overlooked, which could result in heavy tax burden if not carefully handled.[81] It is significant to note that election under Subchapter S will eliminate some pitfalls which confront all corporations, such as the personal holding company tax[82] and the accumulated earnings tax.[83]

Tax Problems

The tax problems or tax traps of which the professional association must be aware are not very numerous, but where they do exist and are not resolved, they may prove quite burdensome. In particular, reference will be made to the problems of transferring the assets from the partnership to an association, of the personal holding company tax, of the accumulated earnings tax and of the possible contention that the professional association is just another tax avoidance device. These matters have been referred to as disadvantages of the professional association, but it is submitted that this is a misnomer since if the matters are correctly handled they can be completely avoided and not merely disadvantageous.

The first pitfall of the new professional association arises when the decision is made to incorporate and the partnership assets are transferred to the association. If the partnership transfers its property to the association solely in return for stock or securities of the association, and immediately after the exchange the transferors have at least eighty per cent of the outstanding voting stock and at least eighty per cent of the total shares of all other classes of stock, then the transfer is a tax-free transaction.[84] But if at the time of incorporation, the partnership has accounts receivable, it has been suggested[85] that the accounts will constitute "unrealized receivables"[86] and be taxed as a sale or exchange of property other than a capital asset.[86a] Furthermore, a transfer of the assets to the association may create a *Lucas v. Earl* situation.[87] There are two possible ways of avoiding this.

81. For an outline of some of the problems, see Deering, *supra* note 80 at 129.

82. INT. REV. CODE OF 1954, §§ 541-547.

83. INT. REV. CODE OF 1954, §§ 531-537.

84. INT. REV. CODE OF 1954, § 351 (a).

85. Eber, *supra* note 80 at 309.

86. INT. REV. CODE OF 1954, § 751 (c).

86a. INT. REV. CODE OF 1954, § 751 (a).

87. Lucas v. Earl, 281 U.S. 111 (1930).

First, the partners might not transfer the accounts receivable to the association, keeping them in the partnership and accounting for them on the partnership's cash basis of accounting. Second, it has been suggested that the partners might transfer the accounts to the association in return for notes payable from the association to themselves so that when a tax is assessed against them they will have the necessary funds available to pay the tax.[88] It is submitted that this method might involve a "boot" transaction under Section 351(b) of the 1954 Internal Revenue Code, and would not achieve the professional's purpose. This accounts receivable problem is not one of overriding importance since there is no indication whether the Commissioner of Internal Revenue intends to pursue it, but obviously the conservative and safe position would be to avoid it if possible.[89]

Another problem of the professional association which should be considered is that of the personal holding company tax.[90] The Internal Revenue Code[91] imposes a tax on the undistributed personal holding company income, which is defined to include personal contracts, at the rate of seventy per cent of such income in addition to the normal corporate tax and surtax. The income from personal service contracts is defined as follows:

> . . . amounts received under a contract under which the contract is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract.[92]

The words "some person other than the corporation" apparently refer to what would be the client in the accounting and law firm and the patient in the medical clinic. With regard to income from personal service contracts, the Internal Revenue Code fur-

88. Buchmann and Bearden, *The Professional Service Corporation—A New Business Entity*, 16 U. MIAMI L. REV. 1, 14 (1961).

89. The case of Thomas W. Briggs, 15 CCH Tax Ct. Mem. 440 (1956), held that where the taxpayer, a sole proprietor, transferred his accounts receivable, which were uncollected service fees, to a corporation the income was properly reflected in the corporation's income for the year and was not to be included in the taxpayer's income. It has been suggested in Alexander, *Some Tax Problems of a Professional Association*, 13 W. RES. L. REV. 212, 213 (1962), that the *Briggs* case might not solve the problem since § 482, allocation of income and deductions among taxpayers, was not timely raised.

90. INT. REV. CODE OF 1954, §§ 541-547.

91. INT. REV. CODE OF 1954, § 541 (a).

92. INT. REV. CODE OF 1954, § 543 (a) (7) (A).

ther provides that the person designated by the client or patient must own at some time during the taxable year twenty-five per cent or more of the outstanding stock of the corporation. Another limitation is that at least sixty per cent of its adjusted ordinary gross income be personal holding company income[93] and that more than fifty per cent of the corporation's outstanding stock be owned, directly or indirectly, by or for not more than five individuals.[94] The personal holding company tax is exorbitant and should always be avoided if the professional association is to be advantageous tax-wise. Obviously, this tax can be avoided by distributing all income of the association or in the case of small associations, by electing to be taxed under Subchapter S. The personal holding company tax may also be avoided by distribution of a "deficiency dividend."[95] A question has been raised[96] as to whether the designation must be made under a written contract. If this is the case, then this will be an out for most professional associations since written contracts, at least as to who will perform the service, are a rarity. However, while there may be no written contract, there would be an implied contract[97] which might satisfy the statute as to designation under a contract. In the event the person designated has others assist him by their performing certain essential tasks, then only that portion of the income attributable to the twenty-five per cent shareholder will constitute personal holding company income.[98] For example, if the senior partner in the law firm has been designated to handle a case and has the junior partners and associates research the law and draft the pleadings, then any fee attributable to the research and drafting would not be personal holding company income, assuming the junior partners and associates do not own a twenty-five per cent interest in the association.

A third problem of which the professional must be aware is the accumulated earnings tax.[99] A tax of 27½ per cent is imposed on any accumulation of earnings beyond the reasonable needs of the business not in excess of $100,000, and a tax of 38½ per

93. INT. REV. CODE OF 1954, § 542 (a) (1).
94. INT. REV. CODE OF 1954, § 542 (a) (2).
95. INT. REV. CODE OF 1954, § 547.
96. Alexander, *Some Tax Problems of a Professional Association*, 13 W. RES. L. REV. 212, 220 (1962).
97. Broadway v. Jeffers, 185 S.C. 523, 194 S.E. 642 (1937).
98. Treas. Reg. § 1.543-1 (6) (8) (ii) (1958), as amended, T.D. 6739, 1964 INT. REV. BULL. No. 28, at 11.
99. INT. REV. CODE OF 1954, §§ 531-537.

cent is imposed on accumulations above $100,000. The key words in this tax are "beyond the reasonable needs of the business."[100] The Fourth Circuit case of *Mountain State Steel Foundries, Inc. v. Commissioner*[101] held that accumulations for the purpose of carrying out a buy-sell agreement between the corporation and one of its stockholders was a reasonable need of the business. Such accumulations might be necessary in professional associations in order to provide funds for buy-sell agreements between the association and the professional. The accumulated earnings tax will rarely apply to a small corporation since the Internal Revenue Code provides for a $100,000 accumulated earnings credit.[102] Therefore, an association may accumulate up to $100,000 in earnings whether or not they are within the reasonable needs of the business. Again it should be noted that if an association elects to be taxed under Subchapter S, the accumulated earnings tax does not apply.

An inherent problem area in all changes to the corporate form of business is whether the purpose of such changeover is to evade or avoid income tax. The Internal Revenue Code prevents any person from acquiring control of a corporation solely for the purpose of avoiding income taxes by securing the benefit of a deduction, credit or other allowance which such person would not otherwise have enjoyed.[103] The burden of proving that the acquisition was made for the "principal purpose" of avoiding income taxation is on the government, but where the purchase price is substantially disproportionate to the interest acquired, the burden shifts to the taxpayer to show there was no purpose of tax avoidance.[104] The Treasury Regulations give examples of the types of transactions to which the Internal Revenue Code applies.[105] Basically, the Treasury Regulations indicate an application to the acquisition of "loss corporations" and to the creation of multiple corporations. Any transfer of assets of a professional partnership to a professional association would not fall within these examples. However, the appropriate section of the Internal Revenue Code, Section 269, is broadly stated and the Commissioner of Internal Revenue might argue that the profes-

100. For a thorough discussion of this point see MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 39.31-39.51 (1956).

101. 284 F.2d 737 (4th Cir. 1960).

102. INT. REV. CODE OF 1954, § 535 (c).

103. INT. REV. CODE OF 1954, § 269.

104. INT. REV. CODE OF 1954, § 269 (c).

105. Treas. Reg. § 1.269.3 (b) and (c) (1962).

sional association is a tax avoidance device, particularly if the partnership organizes under the professional association act and then elects to be taxed as a Subchapter S corporation. It would seem that there should be no distinction made between the financially sound professional partnership which organizes as an association and any financially sound partnership which decides to incorporate. Perhaps, the association might successfully argue that the primary purpose of its creation was not tax avoidance but was sound business planning. That is, the association might logically contend the primary purpose was to achieve limited liability pension plans as inducements to its employees and continuity of life.

Conclusion

Should the attorney, doctor and accountant organize under the professional association act? The difficulty in answering this question affirmatively exists solely in the uncertainty of what position the courts will take regarding the professional association. There is undoubtedly a tax savings and additionally, most of the problems which a professional association may encounter can be resolved. The *Foreman* case is encouragement for the taxpayer. Also, the Treasury Regulations as they now exist would seem to permit the professional association if it conforms to the Kintner-type organization. However, if the proposed Treasury Regulations discussed above are adopted, and thereafter accepted by the courts as the proper construction of the Section 7701 definition of "corporations," the professional association acts will be of little benefit. It must be remembered, however, that the Treasury Regulations are merely the Internal Revenue Service's position in construing the Internal Revenue Code. The Treasury Regulations are persuasive authority nevertheless; sometimes so persuasive they may be considered quasi-legislative in nature. With regard to the importance of Treasury Regulations, Professor Bittker has stated:

> . . . a regulation that was issued soon after the statute it interprets and that has been adhered to consistently by the government will command great respect from the courts, but if contemporareity and consistency are lacking, the courts will be less constrained to accept the regulation.[106]

106. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 28 (2nd ed. 1958).

The proposed Treasury Regulations are neither contemporaneous with the Section 7701 definition of corporations nor are they consistent with the "Kintner Regulations." This, taken with the *Kintner*, *Galt* and *Foreman* decisions, would seem to indicate that the professional associations will receive favorable treatment by the courts.[107] †(*See Ed. Note*).

107. A final perusal of the Code indicates that perhaps the Commissioner will attempt to fight the professional association by means of a Subchapter S provision that unincorporated business enterprises electing under this Subchapter to be taxed as domestic corporations shall not participate in corporate pensions or profit-sharing plans. It is submitted that such an attempt would be unsuccessful in view of the fact that a professional association does *not* elect to be taxed under the Subchapter.

†*Ed. Note:* Since this article was written, the Internal Revenue Service has adopted the proposed amendments to the "Kintner Regulations," making no substantive changes in them. They are reported in place at ¶¶ 11,165, 11,166, 11,172 and 11,172 A of CCH PENSION PLAN GUIDE.