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The Professional Association's Corporate Tax Status

H. W. McDonald Jr.

THE PROFESSIONAL ASSOCIATION'S CORPORATE TAX STATUS

I. Introduction

Under state domestic corporation law professional associations have traditionally been ineligible for corporate status.[1] Underlying this position is the idea that the personal relationship between the professional and his client is such that it precludes having an impersonal corporate structure thrust between the parties.[2] As a result the professional has been denied many of the tax benefits available to corporations, corporate employees, and corporate stockholders. Professionals, however, have sought, and obtained in many cases, corporate status under federal tax law. The purpose of this note is to review the case law, regulations, and statutes that developed out of the efforts by professionals to obtain corporate tax status and to discuss generally the advantages and disadvantages of the professional corporation.

II. Background

A. The Significance of Morrissey

The case of *Morrissey v. Commissioner*[3] dealt with the tax status of a trust created to manage property for a profit. The trust was not formally incorporated and had not, therefore, conformed to the requirements for establishing a corporation under the appropriate state statutes. The Court, however, agreed with the Interval Revenue Service that the definition of a corporation in the Internal Revenue Code[4] was broad enough to include organizations that resembled corporations and that the trust in question sufficiently resembled a corporation to be taxed as such. The Court set forth the following criteria to be used as standards in applying the resemblance test: limited liability, free transferability of interest, centralized management, and continuity of life.[5]

The significance of the *Morrissey* decision lies in the Court's reliance on federal tax law rather than state corporate law to

1. 18 Am. Jur. 2d *Corporations* § 31 (1963).
2. 7 Am. Jur. 2d *Attorneys at Law* § 85 (1963).
3. 296 U.S. 244 (1935).
4. Int. Rev. Code of 1954, § 7701(a)(3).
5. Besides the *Morrissey* standards the professional corporation must meet the "business purpose" doctrine of Gregory v. Helvering, 293 U.S. 465 (1935).

determine whether the trust should be treated as a corporation for tax purposes. Although the professional association could not qualify under state corporate law, it could comply with the resemblance test laid down in *Morrissey.*

B. The Professional vs. The Internal Revenue Service: The Early Cases

In the early cases involving the corporate tax status of professional associations, the Commissioner took the position that professional associations that resembled corporations should not be allowed to escape income tax at the corporate level. The Internal Revenue Service argued in *Pelton v. Commissioner*[6] that a medical clinic organized in the form of a trust with the professionals occupying the position of shareholders sufficiently met the *Morrissey* criteria to be taxed as a corporation. The circuit court agreed and held that the clinic resembled a corporation to the extent that it should be taxed as such. The court noted that a professional practice could not be organized as a corporation under Illinois law, the state in which the clinic was located. But, the court said, federal standards and not state standards are applicable when ascertaining whether or not an organization is a corporation for federal income tax purposes.

The commissioner, however, changed his position in the later cases when professional associations sought to obtain the tax advantages of corporate status. In 1954 the Internal Revenue Service contended in *United States v. Kintner*[7] that an association of doctors could not be a corporation for federal tax purposes. The court, however, rejected the new position and held that for federal tax purposes an association of doctors could have corporate status if it met the criteria established by *Morrissey.* The association considered in *Kintner* met these criteria. Citing *Pelton* as authority, the court reiterated that federal law, and not state law, is the applicable standard by which to judge whether or not an association is a corporation.

In *Galt v. United States*[8] the Internal Revenue Service again asserted its new theory and was again unsuccessful. The *Galt* court was apparently unaware of the *Morrissey*, *Pelton* and *Kintner* cases but rather relied on "the elementary principles of justice" in reaching its conclusion. The Internal Revenue Serv-

6. 82 F.2d 473 (7th Cir. 1936).
7. 216 F.2d 418 (9th Cir. 1954).
8. 175 F. Supp. 360 (N.D. Texas 1959).

ice failed to convince the court that these "elementary principles" were favorable towards its position. Instead, the court said that the federal statutory definition of corporation was broad enough to include doctors' associations such as the one it had under consideration. Although the state law forbad an organization of doctors to incorporate, the court said that federal law was the deciding factor as to the tax status of an organization.

The Internal Revenue Service was again unsuccessful in *Foreman v. United States.*[9] The *Foreman* court noted and followed all of the previous decisions on the issue and, as the *Kintner* court, applied the criteria of *Morrissey* in ascertaining that the association was taxable as a corporation. The court also cited *Galt* as having reached a similar conclusion.

The *Kintner* Court had evaded the Commissioner's argument that it was impossible for the doctor's association to meet the limited liability criterion of *Morrissey.* The state laws applicable to the association did not permit any form of limited liability. The *Foreman* court, however, made no attempt to avoid this argument, but rather conceded that limited liability under state law was impossible and decided that the association satisfactorily met the federal standards for corporate status despite its inability to meet this particular criterion. The court apparently reasoned that the association would have had limited liability except for the express prohibition by state law and that state law could not bar an association from gaining federal corporate tax status. Thus if, because of state law, an association fails to meet a *Morrissey* criterion, that alone is not sufficient to prohibit the association from obtaining corporate status for federal purposes.

III. THE KINTNER REGULATIONS

In an effort to accomplish what it had failed to accomplish by litigation, the Internal Revenue Service promulgated the *Kintner* regulations[10] that were a strict construction of the *Morrissey* criteria. The regulations set forth the four *Morrissey* criteria as necessary elements for federal corporate status and also established certain guidelines for each of these criteria. These guidelines made corporate status for professional organizations an impossibility.

Section 7701(a)(3) of the Internal Revenue Code of 1954 defines a corporation to include "associations, joint-stock com-

9. 232 F. Supp. 134 (S.D. Fla. 1964).
10. Treas. Reg. §§ 301.7701-1-2 (1961).

panies and insurance companies."[11] The *Kintner* regulations explicitly define association as an organization which possesses the characteristics set forth in *Morrissey*.[12] Moreover, the regulations distinguish an "association" from a partnership or a trust.[13] The regulations also provide that if certain of the characteristics are common to both a corporation and another organizational form (*e.g.*, a trust or partnership) these common characteristics are not material in ascertaining whether the organization being considered meets the resemblance test.[14] They give as an example:

> [S]ince centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom.[15]

This provision, of course, completely eliminates the *Morrissey* criteria from consideration in deciding whether an organization is a corporation or trust. Ironically, the decision that was reached in *Morrissey* was based on this exact factual situation. That is, the question in *Morrissey* was whether the organization in question was a trust or an association.

The regulations expressly preclude any partnership subject to the Uniform Partnership Act from possessing the characteristic of centralized management.[16] "[B]ecause of the mutual agency relationship between members of a general partnership. . . [s]uch a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management."[17] Moreover the regulations provide that a partnership subject to the Uniform Partnership Act is incapable of possessing the characteristic of limited liability,[18] since it can not limit its liability under local law. These provisions have had the

11. INT. REV. CODE of 1954 § 7701(a)(3).
12. Treas. Reg. § 301.7701-1(a) (1961).
13. *Id.*
14. Treas. Reg. § 301.7701-2(a)(2) (1961).
15. *Id.* The criteria determined by the regulations to be applicable in this case come from the "business purpose" doctrine of Gregory v. Helvering, 293 U.S. 465 (1935).
16. Treas. Reg. § 301.7701-2(c)(4) (1961).
17. *Id.*
18. Treas. Reg. § 301.7701-2(d)(1) (1961).

greatest impact on professional partnerships. Since at the time of the adoption of the regulations all professional partnerships were subject to the Uniform Partnership Act, it was impossible for such partnerships to obtain corporate status for tax purposes.

IV. THE PROFESSIONAL ASSOCIATION

The adoption of the *Kintner* regulations brought forth a fury of protest from professional circles. The professionals, however, sought and obtained relief from the state legislatures in the form of the Professional Association Acts.[19] These acts exempt professional associations, formed in accordance with the statutes, from the provisions of the Uniform Partnership Act and, therefore, essentially remove the professional associations from the provisions of the *Kintner* regulations applicable to partnerships subject to the Uniform Partnership Act.

The professional association acts of the various states are nearly uniform.[20] In all cases the professional association act is the applicable law governing the professionals that have gained professional association status and the laws applicable to partnerships and private practitioners have no effect on the professional association.[21]

These acts establish a new form of limited liability for qualifying professionals. Although the association is liable for any acts of its agents, the members of the association are not liable individually. There is one exception to this general rule, however, that makes the rule unique. The member of the association who actually performs the act that created the liability incurs individual liability for that act along with the association.[22] This provision answers the criticism that any corporate form of professional practice hampers the personal relationship that should exist between the professional and his client.

These acts also permit the professional association to employ an organizational structure practically identical to that of a domestic corporation.[23] The professional association is permitted

19. *See, e.g.,* FLA. STAT. ANN. § 621.01 *et seq.* (Supp. 1969); GEORGIA CODE ANN. § 84-4301 *et seq.* (Supp. 1968); KY. REV. STAT. ANN. § 274.005 (1969); OHIO CODE ANN. § 1785.01-.06 (1964); S. C. CODE ANN. § 56-1601 *et seq.* (Supp. 1968).
20. *Id.* In the material that follows reference will be made only to the South Carolina Professional Association Act since it may be of greatest interest, and is essentially the same as the other acts.
21. *E.g.,* S. C. CODE ANN. § 56-1616 (Supp. 1968).
22. *Id.* § 56-1607.
23. *Id.* § 56-1608.

to continue as an entity despite the actions, death, or physical or mental infirmity of a member.[24] Moreover, these statutes permit the free transferability of a member's interest in the association provided that the transfer is made to another professional authorized to render the same type of professional service that is rendered by the association.[25] These acts further provide that all laws applicable to domestic corporations are also applicable to professional associations unless they are in conflict with the provision of the Professional Association Act.[26]

Generally speaking, the professional association statutes fall into three groups depending on the status given to professional associations. The more liberal statutes provide that professional associations are corporations.[27] The more conservative statutes provide that professional associations are unincorporated organizations[28] but specify that they are not partnerships.[29] The third group of statutes is somewhere between the two extremes. These statutes designate the organizations as professional associations by name but specifically allow them to obtain corporate status.[30]

V. REGULATION H

"Regulation H,"[31] an amendment to the *Kintner* regulations issued by the Internal Revenue Service in 1965, was an obvious attempt to circumvent the state professional association acts. The amendment, which is entitled "Classification of professional service organizations," provides that a professional organization must not only meet the standards set forth by section (a) of the *Kintner* regulations but it also must meet further requirements established thereunder.[32] "Regulation H" applies to all professional organizations regardless of the label placed on them by state law,[33] deprives a professional organization of corporate status for tax purposes if the organization does not possess the usual characteristics "found in a business corporation,"[34] and specifies certain characteristics as the usual characteristics of a business corporation.

24. *Id.* § 56-1609.
25. *Id.* § 56-1614.
26. *Id.* § 56-1617.
27. *See, e.g.,* FLA. STAT. ANN. § 612.03(2) (Supp. 1969).
28. *E.g.,* S. C. CODE ANN. § 56-1602(b) (Supp. 1968).
29. *Id.* § 56-1603.
30. *E.g.,* OHIO CODE ANN. § 1785.02 (1964).
31. Treas. Reg. § 301.7701-2(h) (1969).
32. *Id.* § 301.7701-2(h)(1)(i).
33. *Id.*
34. *Id.*

The relationship between the professional and his customer, client, or patient is the first characteristic. If this relationship differs from the relationship commonly found between the ordinary business corporation and its clientele, the organization cannot be treated as a corporation. In addition, the relationship between the association members and the public must be the same as the relationship between ordinary business associates and the public.[35]

The second characteristic is a variation of the continuity of life criteria found in *Morrissey*. The regulation provides that a professional organization lacks continuity of life if a member's right to receive his share of the profits is conditioned upon his continued employment. Further, if a member must sell his share of the organization when his employment terminates, then continuity of life does not exist if, in such a case, the remaining members must agree to purchase his share or employ his successor.

The third characteristic is centralization of management. The regulation sets out specific powers that the management of a professional organization must have (*e.g.* the power to hire and fire all employees of the association, the power to establish conditions of employment and the power to determine which professional will handle each individual case). The regulation further provides that in a professional organization there is no centralization of management if a "member [of the professional organization] . . . retains traditional professional responsibility."[36]

The fourth characteristic is limited liability. The regulation provides that the liability of a member of a professional organization must not be any greater than the liability imposed on a "shareholder-employee" of an ordinary business corporation. If the members are subject to a greater liability, the professional organization does not qualify.[37]

The fifth characteristic is free transferability of interest. If a member of the organization must have the consent of the other members before he can transfer either his right to a share of the profits or his right of employment, there is no free transferability of interest. Moreover, if a member must first offer to sell his interest in the profits to the other members before selling to an outsider, there is no free transferability of interest.[38]

35. *Id.* § 301.7701-2(h)(1)(ii).
36. *Id.* § 301.7701-2(h)(3).
37. *Id.* § 301.7701-2(h)(4).
38. *Id.* § 301.7701-2(h)(5)(i)-(ii).

Since the professional association acts provide that the relationship between the professional and his client is to remain unchanged,[39] professional associations could not meet the first requirement of "Regulation H." The limited liability standard of the regulation could not be met because, under the statutes, a member is personally liable for his acts that result in liability for the association.[40]

The standards of continuity of life and centralization of management would also be difficult to meet. The regulation specifically states that the organization does not have centralized management if the professional "retains traditional professional responsibility." Since the professional must still live up to the established standards of professional responsibility, it would be most difficult for a professional organization to achieve centralized management.[41] Although the continuity of life criteria could possibly be met under the statutes, articles of association or by-laws could possibly prevent the organization from meeting this standard. At any rate, since a member's interest can only be sold to another member of his profession,[42] employment with the organization and the rights to profits go hand in hand. A professional must sell his interest in the organization if he has been disqualified from rendering the service performed by the organization.[43] "Regulation H" indicates that the standard of continuity of life could not be complied with if the right to profits is contingent on the members' capacity to be employed.

The free transferability of interest requirement as set forth in "Regulation H" does not present the obstacle that the other "Regulation H" standards present. The professional association acts do not impose any restrictions on the transfer of interest "except as may be lawfully restricted in the Articles of Association."[44] The only problem that confronts the professional organization in regard to this standard, therefore, is the inability of the organization to require that a member must first afford the other members of the organization the opportunity to purchase his interest before he can sell to an outsider. If it does, "Regulation H" states that there is no free transferability of interests.

39. *E.g.*, S. C. CODE ANN. § 56-1607 (Supp. 1968).
40. *Id.*
41. This statement is broad and includes the standards required by medical associations and bar associations.
42. *E.g.*, S. C. CODE ANN. § 56-1614 (Supp. 1968).
43. *Id.* § 56-1611.
44. *Id.* § 56-1610.

VI. THE AFTERMATH OF REGULATION H

To date no court, which has considered the validity of "Regulation H," has upheld the regulation. The courts have used two theories as a basis for their decisions. One theory is that the Internal Revenue Service has exceeded its delegated authority in issuing "Regulation H" and has in effect attempted to legislate a change in the statutory definitions of "corporation" and "partnership".[45] The other theory is that "Regulation H" is arbitrary and discriminates against professional corporations.[46] Of the three circuits that have decided the question, the Sixth and the Tenth Circuits have followed the legislation theory[47] and the Fifth Circuit has followed the discrimination theory.[48] Two district courts have used both theories,[49] and one court held that the regulation was invalid without giving any specific grounds.[50] If and when the Supreme Court decides the question, the theory it chooses may be significant. If the legislation theory is followed, "Regulation H" may still be applicable to professional associations that cannot obtain corporate status under state law.

The essence of the legislation theory is that "Regulation H" is contrary to the statutory definition of a corporation promulgated by Congress. Section 7701(a) (2) of the 1954 code defines partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not, with in the meaning of this title, . . . a corporation . . . ."[51] The term corporation is defined by section 7701(b) (3) to include "associations, joint-stock companies, and insurance companies."[52] Section 7701(a)(4) provides that the "term 'domestic' when applied to a corporation . . . means created or organized in the United States or under the law of the United States or any state or

45. O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Empey, 406 F.2d 157 (10th Cir. 1969); Williams v. United States, 300 F. Supp. 928 (D. Minn. 1969); Cochran v. United States, 299 F. Supp. 1113 (D. Ariz. 1969); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968); Kerzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968).
46. Kerzner v. United States, 413 F.2d 97 (5th Cir. 1969); Williams v. United States, 300 F. Supp. 928 (D. Minn. 1969); O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968).
47. O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Empey, 406 F.2d 157 (10th Cir. 1969).
48. Kerzner v. United States, 413 F.2d 97 (5th Cir. 1969).
49. Williams v. United States, 300 F.Supp. 928 (D. Minn. 1969); Kerzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968).
50. Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968). The court merely stated that it was following all of the other decisions that had found the regulation invalid.
51. INT. REV. CODE of 1954, § 7701(a)(2).
52. *Id.* § 7701(a)(3).

territory."[53] These three sections when read together suggest that a corporation organized under state law is a corporation under the Internal Revenue Code and the courts have specifically held that a state corporation is a corporation for federal tax purposes. Thus "Regulation H" in so far as it applies to professional corporations (*i.e.*, professional service organizations given the status of a domestic corporation by state law) is inconsistent with the statutory definition of a corporation. But is it valid to the extent that it applies to professional associations (*i.e.*, professional service organizations that are designated as professional associations by state law and declared to be unincorporated associations but not partnerships)? Although "Regulation H", to the extent that it applies to professional associations, is not clearly inconsistent with the bare statutory definition of a corporation, it is inconsistent with that definition as interpreted by the Court in *Morrissey*.

Under *Morrissey* an unincorporated organization can qualify as a corporation for tax purposes if it sufficiently resembles a corporation. If the organization meets the resemblance test laid down in *Morrissey* and refined by the *Kintner* regulations, it is characterized as an association and thus it qualifies as a corporation. It could be argued that in applying "Regulation H" to professional associations, the Internal Revenue Service is not legislating a new definition of the term corporation but merely exercising its authority to establish guidelines and explain provisions of the Internal Revenue Code.[54] If, however, "Regulation H" is held to be discriminatory, then it would be invalid to both incorporated and unincorporated professional organizations, because it imposes higher standards for obtaining corporate tax status on unincorporated professional organizations than on other unincorporated organizations such as trusts. The courts that have used the discrimination theory have not adequately explained its legal foundation. It is unclear whether the theory is a constitutional one (*i.e.*, that "Regulation H" is arbitrary and discriminates against professional corporations in violation of the due process clause of the fifth amendment) or whether the theory is based on principles of administrative law. If the discrimination theory is based on administrative law, theoretically

53. *Id.* § 7701(a)(4).

54. *See, e.g.* Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948), *rehearing denied,* 334 U.S. 813 (1948); Halpin v. Collis Co., 243 F.2d 698 (8th Cir. 1951); Gunn v. Dallman, 171 F.2d 36 (7th Cir. 1948), *cert. denied,* 336 U.S. 937 (1949).

the legislative and discrimination theories are one in the same. That is to say, that both theories are based on the same iden— that the Internal Revenue Service has overstepped its authority by issuing regulations not warranted by the language of the code. The particular rationale a court uses may be significant, however. If the discrimination rationale is used, "Regulation H" will be invalid as to both professional corporations and professional associations. But if the legislative rationale is used, "Regulation H" will be invalid as to professional corporations but valid as to professional associations.

Holder v. United States[55] is the only case holding "Regulation H" invalid to the extent that it applies to a professional association. *Holder* involved a medical clinic formed as a professional association under the Georgia Professional Association Act. Georgia, like South Carolina, merely distinguishes a professional association from a partnership without affording it corporate status. The court implied that since the Georgia professional associations are unincorporated under state law, they must measure up to the resemblance standards of *Morrissey* and the *Kintner* regulations. The court carefully analyzed each of the *Morrissey* criteria and specifically pointed out how the Georgia association met each one. The court also concluded that the association in question had fulfilled all of the necessary requirements set forth by the *Kintner* regulations. The court, however, also seemed to imply that all professional organizations, regardless of the state law under which they are formed, must meet the resemblance standard. This position, of course, is questionable since most states have given the professional full corporate status, and, as previously mentioned, once an organization has corporate status under state law, by definition, it has corporate status for federal tax purposes. The court cited with approval the cases of *United States v. Empey*[56] and *O'Neil v. United States*,[57] however, both of these cases involved professional corporations[58] and in *O'Neil* the court said that it was not necessary that a professional corporation meet the resemblance standards of *Morrissey* and the *Kintner* regulations. The *Holder* court concluded that "Regulation H" was "inconsistent with the judici-

55. 289 F. Supp. 160 (N.D. Ga. 1968).
56. 406 F.2d 157 (10th Cir. 1969).
57. 410 F.2d 888 (6th Cir. 1969).
58. *O'Neil* dealt with the Ohio Professional Association Act which gives associations full corporate status although designating them merely as associations. The association in *Empey* was one of lawyers given the power to incorporate under the corporation laws of Colorado by the Supreme Court of Colorado.

ary-determined meaning of the [statutory definitions of corporation and partnership]."[59]

The decision of *Ahola v. United States*[60] is enlightening as to the validity of "Regulation H" as it applies to unincorporated professional associations. The *Ahola* case dealt with a medical clinic formed under the "business trust" provision of the Minnesota statutes.[61] The court determined that the trust sufficiently resembled a corporation to be taxed as such and held that the provisions of "Regulation H" were invalid "because they are inconsistent with all relevant judicial decisions rendered prior to their promulgation, they conflict with the Treasury's prior regulations, and they deliberately discriminate against professional associations formed by doctors or lawyers."[62] These reasons appear to be the soundest argument for "Regulation H's" invalidity as far as unincorporated associations are concerned. The *Ahola* opinion was not based on any inconsistency between the Code and "Regulation H."

The question of the validity of "Regulation H" may never be decided by the Supreme Court, for the Internal Revenue Service may have given up the struggle. On August 8, 1969, the Internal Revenue Service announced in TIR No. 1019 that "organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes."[63] The opinion was qualified, however, and it is unclear whether the Internal Revenue Service will concede corporate tax status to an unincorporated professional association.

VII. THE TAX CONSEQUENCES OF THE PROFESSIONAL ASSOCIATION AND CORPORATION

The primary purpose for the formation of a professional association or corporation is to obtain the tax benefits afforded a corporation. The tax consequences of corporate status, however, are not always favorable to the professional.

The first obvious disadvantage of corporate status is the possible double taxation of the corporate income. The profits of the corporation are taxed as income at the corporate level,[64] and also

59. 289 F. Supp. at 165.
60. 300 F. Supp. 1055 (D. Minn. 1969).
61. MINN. STAT. Extra Session 1961 § 319.02 subdivision 3.
62. 300 F. Supp. at 1060.
63. 7 CCH 1969 STAND. FED. TAX REP. P 6867A.
64. INTERNAL REVENUE CODE of 1954, § 11.

at the shareholder level when dividends are paid.[65] The double tax can be avoided to some extent, however, by disbursing corporate income to the shareholder-employees in the form of salaries. The corporation is allowed a deduction for salaries paid to its employees provided that the salaries "are reasonable."[66] The amount that is reasonable varies from association to association. If the reasonableness of the salaries is ever questioned, the taxpayer has the burden of proving that they are reasonable.[67] Salaries to the extent that they are unreasonable are dividends and are not deductible.

The double taxation of the corporate income may also be avoided by accumulating the income in the association's treasury. This alternative is also beset with problems, however. If it is determined under certain circumstances that the corporation is accumulating earnings to avoid having them taxed as income to the shareholders, a surtax is levied on these earnings in addition to the regular corporate income tax.[68]

There is also a danger that a professional association or corporation will be considered a personal holding company.[69] The Internal Revenue Code imposes a 70 per cent tax on all personal holding company income.[70] One form of personal holding company income is that income derived from contracts which require the corporation to furnish personal services. Such income is taxable under this provision if someone other than the corporation could decide who will furnish the required services.[71] There is an exception to this provision where the person performing the services owns 25 per cent or more of the corporate shares. Thus, if four professionals each own equal shares in the association, the association need not worry about the personal holding company tax.[72]

Another disadvantage is that the payments made by the employee and the association to the old-age, survivors and disability

65. *Id.*
66. Lydia E. Pinkham Medicine Co. v. Commissioner, 128 F.2d 986 (1st Cir. 1942), *cert. denied,* 317 U. S. 675 (1942); Baltimore Dairy Lunch v. United States, 121 F. Supp. 357 (D. Minn. 1954), *aff'd in part, rev'd in part on other grounds,* 231 F.2d 870 (8th Cir. 1956).
67. Lewis Food Co. v. United States, 193 F. Supp. 611 (S.D. Cal. 1961); Oppenheims Inc. v. Kavanagh, 90 F. Supp. 107 (E.D. Mich. 1950).
68. INTERNAL REVENUE CODE of 1954, § 531.
69. *Id.* § 543(a)(1). A personal holding company is an organization which receives 60 per cent of its income in the form of personal holding company income.
70. *Id.* § 543(a)(7).
71. *Id.*
72. *Id.* § 543(a)(7); *see* Alexander, *Some Tax Problems of a Professional Association,* 17 W. RES. L. REV. 212 (1962).

insurance plan are nearly double the payments required of a partner or sole practitioner. In addition, the professional employee is subjected to the federal unemployment tax.[73] As a result of obtaining corporate status the association is confronted with adverse state tax consequence also.[74] The double income taxation aspect appears on the state tax level as well as on the federal level.[75] South Carolina also places a tax on each original share of stock that is issued by the association.[76] In South Carolina a property tax is placed on all property owned by the association and also on the share of the association owned by the professional.[77] The same capital, therefore, is taxed twice.

All of the benefits derived from corporate tax status, however, are dependent on the classification of the members of the professional association as employees of the association.[78]

As an employee, the professional is entitled to certain indirect tax benefits. If disabled the professional may receive workman's compensation benefits that are not included in his gross income.[79] Under certain circumstances amounts received from the association as reimbursement for medical expenses are not included in the employee's gross income.[80] In addition, any payments made to the professional for the loss of a limb or bodily function or disability therefrom are not considered as part of his gross income.[81] Likewise, any payment made by the association under a wage continuation plan is not considered income to the professional if certain conditions are met.[82] At the professional's death his family may receive up to $5,000 from the association without any

73. *Id.* §§ 3101(a)-3111(b).
74. The professional association act explicitly states that the laws regulating domestic corporations will govern the professional associations unless such laws are contrary to the provisions of the Professional Association Act; this includes the tax laws. S.C. CODE ANN. § 56-1617 (Supp. 1968).
75. The association is subject to the South Carolina corporate income tax and the professional as a shareholder is subject to the personal income tax on dividends declared and received by the professional.
76. S.C. CODE ANN. § 65-683-694 (1962).
77. S.C. CODE ANN. § 65-1501 *et seq.* (1962).
78. INTERNAL REVENUE CODE of 1954, § 3121(d)(1). Among other classifications of employees, the code defines employee as "any office of a corporation. . . ."
79. *Id.* § 104(a)(1).
80. *Id.* § 105(b). If the medical expenses had been considered a deduction from the gross income in the employee's tax return, the reimbursement must be included in the employee's gross income. INTERNAL REVENUE CODE of 1954, §§ 105(b), 213.
81. *Id.* § 105(c).
82. *Id.* § 105(d). Self-employed persons are not subject to this provision and must include amounts received under a wage continuation plan in their gross income. INTERNAL REVENUE CODE of 1954, § 105(g).

tax consequences.[83] Income received in the form of stock options is not taxable.

The biggest advantage of corporate status to the professional is the tax benefit that he can receive as an employee by establishing pension, profit-sharing, and stock bonus plans. All of the litigation thus far on the issue of the tax status of professional associations and corporations has involved these plans. The amount contributed to the plans by the employer (the association) is deductible from the employer's gross income[84] if the plans are "qualified."[85] The contributions are not considered income to the employee (the professional) until he has actually received his pension, profit-share, or stock.[86] The effect of the plan is to deflect income from the employee to a trust until he reaches a particular age or retires. When an employee's share is paid over to him at retirement, he is normally in a lower tax bracket than he was when his contributions were made.

To an extent it is possible under the alternative so-called "H.R. 10" plans for the professional as a partner or sole practitioner to establish a retirement plan with the advantages that are available to corporate employees. Under the "H.R. 10" plan the professional is designated as an "owner-employee." The "owner-employee" is defined as one who "owns the entire interest in an unincorporated trade or business [or] . . . is a partner who owns more than 10 per cent of either the capital interest or the profits interest in such partnerships."[87] This concept is somewhat different from the concept of the "common-law employee," which is the status of the professional once he begins performing services for a professional association or corporation. The "H.R. 10" plan is not as attractive to the professional as the plans available to him as an employee of a professional association or corporation.

Whether a plan covers an "owner-employee" or simply an employee, all of the plans must "qualify" under the code to reap the tax benefits. The standards for qualifying an "H.R. 10" plan are much stricter than the standards applicable to employee plans. To qualify an "H.R. 10" plan the code specifies certain requirements that must be met, but which are not requirements

83. *Id.* § 101(b)(2)(A).
84. *Id.* §§ 421-425. The professional's employer is not entitled to a deduction from his gross income of the amount that is difference in the market price of the stock and the amount paid under the option.
85. INTERNAL REVENUE CODE of 1954, §§ 404(a)(1), (a)(3), (a)(5).
86. *Id.* § 402.
87. *Id.* § 401(3).

for qualifying a plan covering only common law employees. When a retirement plan covers one or more "owner-employees" it is required that the trustee of the retirement fund be a bank.[88] In addition, any contributions made to a plan on behalf of an "owner-employee" or a common law employer covered by the same plan are nonforfeitable.[89] It is also necessary to include in the plan[90] all persons who have been employed by the "owner-employee" for three years and payments to an "owner-employee" from the plan cannot be made until he reaches the age of fifty-nine and one-half years of age.[91] None of these specifications are required to qualify a plan which merely covers common law employees. In a retirement plan other than a "H.R. 10" plan, the employer has a great deal more discretion as to who will be covered by the plan and the rights of an employee are forfeitable. The "nonforfeitable" provision and the necessity of including in the plan all employees with three years service are the most unattractive features of an "H.R. 10" plan as far as "qualifying" the plan is concerned.

Another feature of the "H.R. 10" plan that make it unattractive is the limitation placed on the amount that can be contributed to the plan in a single year on behalf of one "owner-employee." The Code restricts the contribution to the amount that can be deducted by the employer.[92] In the case of a professional who is a sole practitioner, he is considered to be his own employer. If the professional is a partner of a firm, the partnership is considered to be the employer of all the partners.[93] The employer in these cases is limited to a deduction of $2,500 or 10 per cent of the earned income, "whichever is the lesser."[94]

Under a plan in which the professional is considered the common law employee of a professional association or corporation, the amounts that may be contributed on his behalf are not so restricted as under the "H.R. 10" plan. In fact, the amount of contribution has no limitation, but there is a limitation on the deduction that can be taken by the employer. Under a pension plan, the employer's deduction is limited to "5 per cent of the

88. *Id.* § 401(d)(1).
89. *Id.* § 401(d)(2).
90. *Id.* § 401(d)(3).
91. *Id.* § 401(d)4(B).
92. *Id.* § 401(d)(5).
9.3 *Id.* § 401(c)(4).
94. *Id.* § 404(e)(1) (Supp. 1969).

compensation otherwise paid or accrued during the taxable year to all the employees under the trust . . ."[95] The deductions available to an employer for contribution to a stock-bonus or profit-sharing trust is limited to 15 per cent.[96] There is also an overall deduction limit of 25 per cent for contributions made by the employer to the conglomerate of profit sharing, pension annuity and stock bonus plans.[97] However, if more than 25 per cent is contributed in one year, the excess may be carried over to subsequent years but the total deductions in subsequent years cannot exceed 30 per cent of the compensation.[98] The professional association or corporation, therefore, has a maximum available deduction of 30 percent compared to the $2,500 maximum deduction available to an employer under an "H.R. 10" plan. But more importantly there is no limitation placed on the amount of contribution, whereas under an "H.R. 10" plan the contribution may not exceed 10 per cent of the earned income or $2,500.

CONCLUSION

The struggle by the Internal Revenue Service in attempting to prevent professional associations from obtaining corporate status for tax purposes has thus far been most unsuccessful. On August 8, 1969, the Internal Revenue Service conceded defeat to an extent but not without qualification. Its statement that "generally" the professional association will be given corporate status except in "special circumstances" indicates that it obviously intends to continue to attack the corporate status of some professional associations. The Internal Revenue Service may argue that "Regulation H" is valid and applicable to all professional associations as opposed to professional corporations. In light of the many decisions that have declared "Regulation H" invalid as applied to professional corporations, the Internal Revenue Service has, no doubt, at least conceded that "Regulation H" is invalid insofar as these professional organizations are concerned.

Although "Regulation H" may be invalid, no court, which has confronted the question, has invalidated the original *Kintner* regulations. These regulations are generally recognized to be inapplicable to professional corporations, but in ascertaining the

95. *Id.* § 404(a)(1).
96. *Id.* § 404(a)(3).
97. *Id.* § 404(a)(7).
98. *Id.*

tax status of an unincorporated professional association, they are as applicable as are the *Morrissey* criteria. All unincorporated organizations must meet these regulations before they can be classified as corporations for tax purposes.

The end of the struggle between the Internal Revenue Service and the professional over corporate status may be drawing to a close. At any rate, the professional has come a long way since *Morrissey* and is the victor at the moment. Always lurking in the background, however, is the prospect that Congress may be persuaded by the Internal Revenue Service to change the statute. Nothing is sacred in tax law.

H. W. McDONNALD, JR.