

1958

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Recommended Citation

H. Bradley Jones, *The Professional Corporation*, 27 Fordham L. Rev. 353 (1958).

Available at: <https://ir.lawnet.fordham.edu/flr/vol27/iss3/3>

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The Professional Corporation

Cover Page Footnote

Member of the California Bar.

THE PROFESSIONAL CORPORATION

H. BRADLEY JONES*

DURING the last war, posters appeared on the bulletin boards of many plants wryly pronouncing the principle that "a bumblebee can't fly." Aerodynamic laws of lift, thrust, and drag clearly so demonstrated. The defiant bee in flight across the poster was of course intended to stimulate inquiry among the chairborne engineers and designers of democracy's arsenal. An ordinary airplane having the same relative weight and wingspan of a bee could not fly *with the conventional power then available*. Today's wingless missiles go the bee one better. The laws of physics remain the same. The difference lies in their practical and useful application by inventive and open-minded men.

Statutes, cases, and canons of ethics uniformly state that "a corporation cannot practice law." Less uniformly, similar principles today apply to the professions of medicine, accountancy, and architecture. Wherever applied, this doctrine operates to deprive the practitioner of many opportunities for tax shelter, business continuity, and business planning which are otherwise available under existing tax laws only when business is done in the corporate form. Nevertheless, the doctrine is entirely correct when it operates so to limit practice of a profession by the ordinary business corporation *with the conventional powers and attributes now available* under existing state law. Such a corporation should not be permitted to practice a profession.¹

What lawyer in private practice would welcome such corporate competition? Many lawyers are all too conscious of the modern erosion of the scope of the practice of law by lay competitors who are so frequently unencumbered by training commensurate with theirs and also seem occasionally to be unfettered by anything equivalent to their standards of ethics. Struggles with banks, accountants, title companies, escrow companies, and collection agencies over unlawful practice of law have long required the devoted common effort of the organized bar. The list of such antagonists of the profession seems to grow year by year. Trust companies and insurance companies with their armies of solicitors, estate planners, pension and profit sharing planners, management and labor relations consulting firms, and a host of other corporate mercenaries

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1. See articles on this problem by Wormser, *Corporations and the Practice of Law*, 5 *Fordham L. Rev.* 207 (1936); Lewis, *Corporate Capacity to Practice Law: A Study in Legal Hocus-Pocus*, 2 *Md. L. Rev.* 342 (1938); Comment, *Corporations—Doing Professional Services Through Others*, 45 *Mich. L. Rev.* 885 (1947).

appear to encircle the embattled private practitioner of law like a mythical crop of dragon's teeth.

Fidelity to the concept that a layman must not be permitted, directly or indirectly, to practice a licensed learned profession is basic to this inquiry. By examining the reasons for the prohibitions against practice of the professions by business corporations can we devise a statutory corporate entity which has none of the professional dangers or defects of the conventional business corporation, and which consequently would afford many professional practitioners the tax and business advantages which their commercial brethren enjoy? What are the desired advantages and how successful have efforts been to gain some measure of tax equality during recent years through alternative legislative proposals? Are any of these alternatives as favorable to the professional man as the privilege of practicing his profession under the tax shelter of a professional corporation?

THE PROHIBITIONS AND THEIR PRESENT EXTENT

Many reasons for the prohibition against the practice of certain professions by business corporations operated for profit have been advanced or discussed by the courts and professional committees on ethics. Other objections can be inferred from applicable statutes. The chief reasons can be summarized as follows:

1. A corporation is not eligible for a license to practice the profession; hence, such practice is not a "lawful purpose" for which a corporation may be formed.
2. The relation of the practitioner of a profession and his client or patient is purely personal; statutory prerequisites to the right to practice are high and form a basis for trust and confidence. A corporation cannot have these personal qualifications and would not be deserving of the same personal trust.
3. If a corporation employs a practitioner, his first duty is to his employer rather than to the client or patient. He would be subject to the directions of his employer rather than to those of his client or patient.
4. A "middleman" should not, as a matter of public policy, be permitted to intervene for profit in establishing the professional relationship between the practitioner and members of the public.
5. Priority of contract would be with the corporation, not the practitioner.
6. Even if all officers and directors are licensed, transfer of their shares by sale, operation of law, or succession would result in unlicensed laymen profiting from the practice of a profession through

share ownership in such a corporation. Marketable shares descendible under the laws of inheritance are objectionable.

7. The corporation could not be disbarred or suspended.
8. Unscrupulous practitioners might find shelter from liability in corporations in cases of malpractice claims, particularly in the medical professions.

Corporate Practice of Law

In respect to corporate practice of law, perhaps one of the best judicial statements of reasons for the doctrine is found in the New York case, *Matter of Co-operative Law Co.*,² which held that a statute permitting three or more persons to form a corporation "for any lawful business" purpose does not permit the formation of a corporation to practice law. The court stated:

The practice of law is not a business open to all, but a personal right, limited to a few persons of good moral character, with special qualifications ascertained and certified after a long course of study, both general and professional, and a thorough examination by a state board appointed for the purpose. The right to practice law is in the nature of a franchise from the state conferred only for merit. It cannot be assigned or inherited but must be earned by hard study and good conduct. It is attested by a certificate of the Supreme Court and is protected by registration. No one can practice law unless he has taken an oath of office and has become an officer of the court, subject to its discipline, liable to punishment for contempt in violating his duties as such, and to suspension or removal. It is not a lawful business except for members of the bar who have complied with all the conditions required by statute and the rules of the courts. As these conditions cannot be performed by a corporation, it follows that the practice of law is not a lawful business for a corporation to engage in. As it cannot practice law directly, it cannot indirectly by employing competent lawyers to practice for it, as that would be an evasion which the law will not tolerate

The relation of attorney and client is that of master and servant in a limited and dignified sense, and it involves the highest trust and confidence. It cannot be delegated without consent, and it cannot exist between an attorney employed by a corporation to practice law for it, and a client of the corporation, for he would be subject to the directions of the corporation, and not to the directions of the client. There would be neither contract nor privity between him and the client, and he would not owe even the duty of counsel to the actual litigant. The corporation would control the litigation, the money earned would belong to the corporation, and the attorney would be responsible to the corporation only. His master would not be the client but the corporation, conducted it may be wholly by laymen, organized simply to make money and not to aid in the administration of justice which is the highest function of an attorney and counselor at law. The corporation might not have a lawyer among its stockholders, directors or officers. Its members might be without character, learning or standing. There would be no remedy by attachment or disbarment to protect the public from imposition or fraud, no stimulus to good conduct from the traditions of an ancient and honorable profession, and no guide except

2. 198 N.Y. 479, 92 N.E. 15 (1910).

the sordid purpose to earn money for stockholders. The bar, which is an institution of the highest usefulness and standing, would be degraded if even its humblest member became subject to the orders of a money-making corporation engaged not in conducting litigation for itself, but in the business of conducting litigation for others. The degradation of the bar is an injury to the state.

A corporation can neither practice law nor hire lawyers to carry on the business of practicing law for it any more than it can practice medicine or dentistry by hiring doctors or dentists to act for it. . . . The legislature in authorizing the formation of corporations to carry on "any lawful business" did not intend to include the work of the learned professions. Such an innovation with the evil result that might follow would require the use of specific language clearly indicating the intention.³

Prohibition of corporate practice of law has since been reaffirmed by decisions to similar effect and with similar reasoning.⁴ At least one court has proleptically questioned the constitutionality of any legislation which might permit corporate law practice.⁵

Moreover, the Canons of Ethics of the American Bar Association speak plainly on the issues of control being interposed between lawyer and client⁶ and the sharing of income with laymen (stockholders).⁷ In 1950, a group of lawyers sought to avail themselves of the then apparent tax advantages of practice through the form of a Massachusetts (business) trust. One of the lawyers sought the opinion of the Committee

3. *Id.* at 483-84, 92 N.E. at 16.

4. *Boykin v. Hopkins*, 174 Ga. 511, 162 S.E. 796 (1932); *People v. California Protective Corp.*, 76 Cal. App. 354, 244 Pac. 1089 (1926); *People v. Merchants' Protective Corp.*, 189 Cal. 531, 209 Pac. 363 (1922); *People ex rel. Ill. State Bar Ass'n v. People's Stock Yards State Bank*, 344 Ill. 462, 176 N. E. 901 (1931); *State v. Merchants' Protective Corp.*, 105 Wash. 12, 177 Pac. 694 (1919).

5. *In the Matter of Opinion of the Justices*, 289 Mass. 607, 194 N.E. 313 (1935).

6. *Intermediaries*:

"The professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer. A lawyer's responsibilities and qualifications are individual. He should avoid all relations which direct the performance of his duties by or in the interest of such intermediary. A lawyer's relations to his client should be personal and the responsibility should be direct to the client. Charitable societies rendering aid to the indigent are not deemed such intermediaries.

A lawyer may accept employment from any organization, such as an association, club or trade organization, to render legal services in any matter in which the organization, as an entity, is interested, but this employment should not include the rendering of legal services to the members of such an organization in respect to their individual affairs." *Canons of Professional Ethics of the American Bar Association*, Canon 35 (1949).

7. *Division of Fees*:

"No division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility. But sharing commissions between forwarder and receiver, at a commonly accepted rate, upon collections of liquidated commercial claims, though one be a lawyer and the other not, is not condemned hereby, where it is not prohibited by statute." *Canons of Professional Ethics of the American Bar Association*, Canon 34 (1949).

on Professional Ethics. The committee turned the idea aside, chiefly on those grounds.⁸

Corporate Practice of Medicine

The general rule remains that corporations operated for profit may not practice medicine, even through employees who are duly licensed physicians and surgeons.⁹ The same rules seem to apply to all of the healing arts, such as dentistry,¹⁰ chiropody (podiatry),¹¹ and ophthalmology.¹²

The growth of health plans, tax pressures, and the expediencies of hospitals have produced a number of exceptions to the rule. For example, patients may incorporate to *purchase* low cost medical services, if the corporation is not formed for profit.¹³ Statutes authorizing Blue Cross and Blue Shield medical plans are almost universal. A sanitarium corporation providing medical care, even though operated for profit, can collect for professional services rendered by its employees under Texas law.¹⁴ In Missouri, although a corporation operated for profit may not practice medicine, it may do so indirectly through licensed physician-employees.¹⁵ The emerging social need for adequate medical services at a cost within the means of the great mass of voters has undeniable attraction for state legislators. In medicine, the line of demarcation is becoming increasingly blurred. Nonprofit corporations practice medicine almost everywhere and the patients' bills are more frequently paid by insurance or health plan corporations or welfare funds than by themselves.

Although the courts and legislatures have evidenced their willingness to relax this stricture, advisers on ethics within the medical profession have not entirely capitulated. Many clinics have recently quite understandably sought to avail themselves of the tax benefits of a *Kintner*¹⁶

8. Opinion of Professional Ethics Committee, No. 283, 36 A.B.A.J. 370 (1950).

9. *People v. United Medical Serv. Inc.*, 362 Ill. 442, 200 N.E. 157 (1936); Annot., 103 A.L.R. 1240 (1936).

10. *Dr. Allison, Dentist, Inc. v. Allison*, 360 Ill. 638, 196 N.E. 799 (1935). But see *Lewis v. Woodbury Dental Parlors Co.*, 106 Misc. 78, 175 N.Y. Supp. 269 (Sup. Ct. 1919); *State ex rel. Bloom v. State Bd. of Dental Examiners*, 96 Ore. 529, 188 Pac. 960 (1920).

11. *Pilger v. City of Paris Dry Goods Co.*, 86 Cal. App. 277, 261 Pac. 328 (1927).

12. *Drucker v. Medical Examiners*, 143 Cal. App. 2d 702, 300 P.2d 197 (1956); see Annot., 102 A.L.R. 343 (1936); Annot., 128 A.L.R. 585 (1940).

13. *California Physicians' Serv. v. Garrison*, 28 Cal. 2d 790, 172 P.2d 4 (1946).

14. *Republic Reciprocal Ins. Ass'n v. Colgin Hosp. & Clinic*, 123 Tex. 31, 65 S.W.2d 286 (1933).

15. *State ex inf. Sager v. Lewin*, 128 Mo. App. 149, 106 S.W. 581 (1907); see also *State Electro-Medical Institute v. State*, 74 Neb. 40, 103 N.W. 1078 (1905).

16. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). This decision is discussed at pp. 364-65 *infra*.

form of association taxable as a corporation. At least one medical association has cautioned its members against embarking upon such a venture because of "the inherent inconsistency of a medical group of physicians seeking corporate status for tax purposes but denying corporate status for all other purposes (such as medical ethics and the requirements of the Medical Practice Act)."¹⁷ The California "requirements" refer to section 2008 of its Business and Professions Code which provides, in part, that "corporations and other artificial legal entities have no professional rights, privileges or powers. . . ."¹⁸

The ethical inhibitions upon doctors are steadily changing. Compare the former American Medical Association statement on this matter which reads: "A physician should not dispose of his professional attainments or services to any hospital, lay body or organization, group or individual, by whatever name called, or however organized, under terms or conditions which permit exploitation of the services of the physician for the financial profit of the agency concerned,"¹⁹ with the present provision which says merely that: "A physician should not dispose of his services under terms or conditions which tend to interfere with or impair the free and complete exercise of his medical judgment and skill or tend to cause a deterioration of the quality of medical care."²⁰ Significantly, the suggestion of the addition of the phrase "or permit the sale of his professional services by any lay person or corporation" was *rejected* by the doctors.²¹

Nevertheless, group medical practice by clinics is clearly on the in-

17. Field, *Medical Groups-Pension Plans*, 88 Los Angeles County Medical Bull. No. 9, at 31 (May 1, 1958).

18. Cal. Bus. & Prof. Code § 2008. See note 6 *supra*.

19. Principles of Medical Ethics of the American Medical Ass'n ch. VII, § 3 (1951).

20. Principles of Medical Ethics § 6 (adopted in 1957), 164 A.M.A.J. No. 13, at 1484 (1957).

21. In 1957 the House of Delegates of the American Medical Association reaffirmed the "Guides for Conduct for Physicians in Relationships with Institutions" which had been adopted in 1951. The Guides suggested certain general principles, including: "1. A physician should not dispose of his professional attainments or services to any hospital, corporation or lay body by whatever name called or however organized under terms or conditions which permit the sale of the services of that physician by such agency for a fee." 164 A.M.A.J. 1118-20. Also in 1957, the House of Delegates endorsed the following statement of a reference committee: "Your reference committee is impressed by the necessity of informing all physicians and the general public as to the evils which may be inherent in the socialization of medicine through corporate activity as well as by government action. . . . In many of its forms it is indistinguishable in practice and effect from socialization of medicine and appears to embody all its evils. . . . Your reference committee therefore recommends that the problem be referred to the Board of Trustees with the request that it devise and initiate a campaign to educate both physicians and the general public as to the dangers inherent in the illegal corporate practice of medicine in its various forms."

crease throughout the country. Where state law inhibits the conduct of a clinic in corporate form, a separate profit corporation is not infrequently formed to conduct some of its business aspects.²² Moreover, at least one commentator has contended that the practice of medicine is in fact a lawful corporate purpose.²³

Corporate Practice of Accounting

Although the accounting profession flatly forbids, as a matter of professional ethics,²⁴ practice of any member in the corporate form, corporate practice of accountancy is specifically *permitted* by the laws of California,²⁵ Georgia,²⁶ Illinois,²⁷ Iowa,²⁸ Michigan,²⁹ Missouri,³⁰ North Carolina,³¹ Texas,³² and Wisconsin.³³ However, even in California a

22. Group Medical Practice and Clinics—Some Organizational Problems, 4 Stan. L. Rev. 401, 411-13 (1952).

23. Note, Right of Corporation to Practice Medicine, 48 Yale L.J. 346, 348 (1938), where the author says, in part:

"Courts which profess to deny all corporations the right to have any connection with medical activities have apparently misconstrued the purpose of the state licensing statutes. These statutes are designed to preserve the public health by excluding from practice persons with inadequate ability, morality, and training. Since the diagnosis and treatment of disease are obviously purely personal functions, a corporation can perform them only through the medium of doctors. But the mere fact that a corporation employs physicians, or is operated by physicians, provides no valid basis for requiring the corporation itself to be licensed. As long as the doctors are properly licensed and their professional activities are not interfered with by unlicensed persons, the purpose of the statutes is fully effected, for no one without proper qualifications is then directly or indirectly administering to the public. This is true even though laymen may be entrusted with considerable control over administrative details. Only when lay officers or directors exercise substantial supervision over the professional activities of the physicians employed is there ground for arguing that the corporation is enabling unlicensed persons to practice medicine. Thus the real issue is not whether corporations generally are unlicensed to practice medicine, but whether in each individual case physicians are actually controlled in their purely professional functions by unlicensed persons in such a manner as to nullify the purpose of the licensing statutes."

24. This prohibition is found in Rule 11 of Rules of Professional Conduct, American Institute of Accountants, as revised Dec. 19; 1950, 1 C.P.A. Handbook, ch. 5, p. 6, which provides: "A member shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia."

25. Cal. Bus. & Prof. Code § 5062.

26. Ga. Code Ann. § 84-215 (1935).

27. Ill. Ann. Stat. c. 110½, § 39 (Smith-Hurd 1956).

28. Iowa Code § 116.6 (1954).

29. Mich. Stat. Ann. § 18.13 (1957).

30. Mo. Rev. Stat. § 326.020 (1949).

31. N.C. Gen. Stat. § 93-6 (1950).

32. Tex. Rev. Civ. Stat. art. 41a § 10 (1948).

33. Wis. Stat. § 135.07 (1955).

corporation cannot qualify as a *certified* public accountant³⁴ and the tendency there seems to be toward making restrictions on corporate practice of accountancy more, rather than less, exacting.³⁵

Corporate Practice of Architecture

Corporate practice of architecture is prohibited in Colorado,³⁶ Pennsylvania,³⁷ and New York (unless the corporation was formed prior to 1929),³⁸ but seems to be lawful in Arkansas,³⁹ Georgia,⁴⁰ Illinois,⁴¹ and Texas.⁴² Florida will not license an architectural corporation, but permits a licensed shareholder to recover for services performed in its name.⁴³ In California, a corporation may not obtain a certificate, but it can contract to provide the services of certificated architects or collect for its services as a non-certificated person, if it has disclosed its lack of a certificate.⁴⁴ Nevertheless, the American Institute of Architects announces this approach to the matter: "Corporations may not practice and in the case of a firm, all the members must be licensed if their names are to appear."⁴⁵

PROPOSAL FOR A FORM OF PROFESSIONAL CORPORATION

Having isolated the reasons for and defined the scope of this limitation on business organization of these professions, it should not be an insuperable task to describe and to legislate into existence an acceptable form of "professional corporation." Such a corporation should be subject to the supervision and regulation of the state administrative agencies and official state boards regulating both corporations in general and the profession which the particular corporation is formed to practice. Such a professional corporation should have, as a matter of state statutory law, the following limitations and special characteristics:

1. All of its officers, directors, and shareholders shall be persons licensed to practice the profession by the state of domicile.

34. Cal. Bus. & Prof. Code § 5091; *Accounting Corp. v. State Bd. of Accountancy*, 34 Cal. 2d 186, 208 P.2d 984 (1949).

35. Cal. Bus. & Prof. Code § 5062.

36. Colo. Rev. Stat. Ann. § 10-2-10(2) (1955).

37. Pa. Stat. tit. 63, § 31 (1936).

38. N.Y. Educ. Law § 7307(2).

39. Ark. Stat. § 71-302(3) (1947).

40. *Folsom v. Summer, Locatell & Co.*, 90 Ga. App. 696, 83 S.E.2d 855 (1954).

41. Ill. Rev. Stat. c. 10½, § 3 (1955).

42. Tex. Rev. Civ. Stat. art. 1302(45) (1948).

43. *Robert L. Weed, Architect, Inc. v. Horning*, 159 Fla. 847, 33 So. 2d 648 (1947).

44. *Binford v. Boyd*, 178 Cal. 458, 174 Pac. 56 (1918).

45. *Handbook of Architectural Practice* pt. 1, ch. 1, at 13 (1953).

2. No professional corporation shall be permitted to practice more than one licensed profession.
3. Shares may be held only by such licensees who are natural persons and no professional corporation may hold stock in another professional corporation, merge or consolidate with a foreign professional corporation, or permit any lay person at any time to own any of its shares.
4. Shares shall not be transferable without the consent of the state agency licensing the profession, except in retirement or redemption thereof by the corporation or among the existing shareholders of the corporation. Shares may be issued only with the consent of the state licensing agency.
5. The professional corporation shall afford no limitation on the liability of its officers, directors or shareholders for any errors, omissions, malpractice or other torts committed by its agents, employees, officers, directors, or shareholders in the scope of their employment by or professional activities on behalf of the corporation.
6. No layman shall have any part in the ownership, management, or control of the corporation. No proxy may be given to any person to vote any shares of the corporation other than a person licensed by the law of the state of corporate domicile to practice the profession of the corporation.
7. Upon the death or retirement of a stockholder, the corporation must purchase, redeem, or retire all of the shares of such stockholder out of capital as well as surplus without restriction, unless the shares are promptly purchased by the remaining shareholders of the corporation or other licensed practitioners (with the consent of the state licensing agency). This redemption may require execution by the remaining shareholders of a bond or undertaking to be delivered to the state agency governing the practice of the profession, indemnifying creditors of the corporation, and shall be lawful even though such purchase or redemption temporarily renders the corporation insolvent.
8. The corporation's license to practice the profession shall be subject to revocation in any of the following events:
 - a) upon the revocation of the professional license of any officer, director, or shareholder not promptly retired by the corporation;
 - b) should any judgment for malpractice against the corporation remain unsatisfied;
 - c) upon the final order, after appropriate hearing, of the state

agency governing the profession, upon petition of such agency or any shareholder of the corporation having a grievance on the grounds of a violation of the standards or rules of ethics of the licensed profession against the corporation, its officers or directors; of any client or patient of the corporation; or of the Attorney General of the state;

- d) upon the death or surrender of the license of the last remaining shareholder of the corporation.

Such a "professional corporation" should, it is submitted, satisfy all of the objections previously described. No creeping corporate monster could cross state lines, as many professional partnerships (e.g., national accounting firms) now do. No layman could share its profits, intervene between the professional man and his patient or client, or deprive the relationship of its essential trust and confidence. No practitioner could avoid responsibility or liability for his malpractice, errors, or omissions. The corporation can be disbarred, suspended, or lose its professional license for the misconduct of its owners, agents or employees in the same manner as an individual practitioner. A legal entity, it is no more an "intermediary" than a professional partnership or association requiring duties among partners or associates as well as duties toward the patient or client. All of its members must have the character, learning, and standing required of its profession. No bank, lay association, commercial or nonprofit corporation may own or control the professional corporation.

Doubtless many professional men will recognize how closely the professional corporation reflects the practical aspects of their day-to-day operations. Others, with becoming and native conservatism, will approach this concept with extreme caution. Some may flatly refuse to re-examine the issues involved and prefer to continue to operate with maximum personal exposure to state and federal taxation.

Admittedly, the foregoing suggestions cry out for refinement and closer study, require precise consideration and hard work by legislative draftsmen and lobbyists for the affected professions in the several states, and demand full and open critical discussion wherever the second-class professional taxpayers congregate. These imperatives are based upon the fact that no other proposal for our specific tax relief has had any success in Congress to date.

OTHER PROPOSALS FOR TAX RELIEF

The need for tax relief for the professions has long been generally recognized.⁴⁶ Early proposals advocating application of corporate fed-

46. Wolder, *The Forgotten Men of Taxes*, 24 *Taxes* 970 (1946).

eral income tax rates to enterprises which could not incorporate under state law, after an allowance for "reasonable, constructive salaries" to the principals⁴⁷ met with serious objections⁴⁸ and vanished in legislative limbo. Even when the Internal Revenue Code of 1954 was passed containing the ill-fated privilege of certain partnerships to elect to be taxed as corporations,⁴⁹ professional partnerships were specifically excluded⁵⁰ from the privilege.

Legislative treatment of proposals to put private professional practitioners on an equal footing with corporate employees in respect to pension, profit sharing, or retirement trust participation has been equally unsuccessful in Congress. At first, it was hoped that existing provisions of the income tax laws could be extended to include partners and sole proprietors,⁵¹ inadequate as it appeared to some.⁵² The debate was an exhaustive one, rightly concerning itself with attempts to predict the "Treasury's attitude on loss of revenue," what kind of securities could be used to fund such plans and other niceties dear to the hearts of so many lawyers, particularly in published debate. The struggle is spread upon the Reports of the Committee on Federal Income Taxes of the Section of Taxation of the American Bar Association from 1947 through 1950. Result: no single specific proposal for legislation. Congress, however, was innocent of any blame in the matter, since the law profession was itself unable to agree.

During the years 1950 through 1955, the concepts of "averaging" income over a period of time to equalize taxes on fluctuating incomes had their day in the sun. These plans were varied and complex.⁵³ A tax imposed upon annual net income at the graduated individual rates was, by now, with cited dramatic examples of prize fighters with big purses and short careers, the target. By 1953, the American Bar Association Committee had determined to give legislative support to the Bravman plan, after debating several others. Yet no such provision appears today in the Internal Revenue Code or in the income tax laws of any state.

One proposal has met with less internecine distress. Popularly called

47. Hearings on Proposed Revisions of the Internal Revenue Code Before the House Ways and Means Committee, 80th Cong., 1st Sess., pt. 3, at 1717-22 (1947).

48. Silverson, *Earned Income and the Ability to Pay*, 3 *Tax. L. Rev.* 299 (1948).

49. *Int. Rev. Code of 1954*, § 1361. This privilege of election was revoked by § 63 of the *Technical Amendments Act of 1958*.

50. *Int. Rev. Code of 1954*, § 1361(b)(4).

51. Nicholson, *Pensions for Partners: Tax Laws Are Unfair to Lawyers and Firms*, 33 *A.B.A.J.* 302 (1947).

52. Rudick, *More About Pensions for Partners*, 33 *A.B.A.J.* 1001 (1947).

53. Bravman, *Equalization of Tax on All Individuals with the Same Aggregate Income Over the Same Number of Years*, 50 *Colum. L. Rev.* 1 (1950).

the "Jenkins-Keogh Bill," it was originally introduced in 1951.⁵⁴ Re-introduced in both the 83rd and 84th Congresses, it reached its previous highwater mark when it was approved by the House Ways and Means Committee on July 19, 1955. It has the support of the organized bar.⁵⁵ Passed by the House on July 29, 1958, a modified form of HR9 and HR10 was permitted to die in the Senate amid a chorus of assurances of reintroduction at the next session. The proposal is, simply stated, to permit self-employed individuals and groups to contribute to and participate in pension plans subject to restrictions and with benefits comparable to the features of a qualified plan under section 401 of the Internal Revenue Code of 1954, from which professionals are now excluded. The literature on the proposal is too extensive and its purport too well known to be here repeated.⁵⁶ Its performance in Congress, where it is tactfully opposed by the Treasury,⁵⁷ does not distinguish it from any of its predecessors above summarized or now pending,⁵⁸ despite all of the deserved support it continues to receive from the professions.

KINTNER ASSOCIATIONS AND THE PROFESSIONAL CORPORATION

In the midst of unremitting legislative disappointments, the Ninth Circuit gave considerable comfort to many when it permitted an unincorporated association of doctors in Missoula, Montana, to pay their taxes as a corporation and enjoy the benefits of a qualified pension plan over the strenuous objections of the Treasury Department based chiefly on the fact that a corporation cannot practice medicine under Montana

54. H.R. 4371, H.R. 4373, 82d Cong., 1st Sess. (1951), then popularly called "Reed-Keogh."

55. Approvals by the House of Delegates and by local bar associations are summarized in 1 A.B.A. News, No. 1, at 2 (July 16, 1956). Moreover, the ABA Committee on Pensions and Other Deferred Compensation has strongly endorsed it in principle. Similar action has been taken by the American Medical Association and local medical associations and the American Institute of Accountants.

56. Note, Favorable Tax Treatment for Individual Pension Plans: The Jenkins-Keogh Bill, 66 Harv. L. Rev. 1105 (1953); Keogh, Social Security Legislation and the Jenkins-Keogh Bill, 28 N.Y.B. Bull. 273 (1956); Trigg, Jenkins-Keogh Bills—What They Mean to the Lawyer, 24 The Detroit Law. 3 (1958).

57. Congressman Keogh has been quoted as reporting that: "The Treasury Department has gone on record as approving the principle of this legislation, but as opposing one of its consequences—namely, the revenue loss that would be sustained by the Federal Treasury." (See 28 N.Y.B. Bull. 273, 277.) Treasury estimates of revenue loss have ranged from \$660,000,000 in 1956 to \$400,000,000 in the 1958 Hearings. Proponents say it will cost only about \$100,000,000 in taxes during its early years. 3 A.B.A. News No. 2, at 2 (February 15, 1958).

58. The Sparkman Bill, S. 3194, 85th Cong., 2d Sess. (1958), providing for 10% of earned income or \$1,000 per year to be deductible each year if set aside for retirement is illustrative.

law.⁵⁹ Those lawyers who cautiously awaited Treasury reaction to the decision, for months exercising uneasy restraint on their clients, were rewarded for their prudence when the Treasury not only failed to acquiesce but announced its determined opposition to the plan.⁶⁰ There the matter seemed to rest, except among some adventurers who chose to gamble (particularly in the shelter of the Ninth Circuit), until the Treasury tantalizingly issued Revenue Ruling 57-546 on October 10, 1957, "modifying" its prior position, but concluding with the gift of the following package (with its oddly disturbing ticking sound): "Basic criteria to be used in testing the existence of an association taxable as a corporation will be stated in a Revenue Ruling to be published at a later date."⁶¹ No such ruling has been forthcoming to date. Consequently, most lawyers have immersed the package in a water bucket for the time being, as much out of respect for the intended professional recipient's prior record of tax misfortunes as out of native distrust of the sender.

Less cautious (or more openly desperate) practitioners have formed *Kintner* associations, some of them avowedly declaring that they have little to lose by giving it a whirl. How-to-do-it articles on the subject appeared while the ink had barely dried on the opinion.⁶² The *Kintner* Articles of Association have been widely published.⁶³ Nevertheless, after prodding the Treasury a little,⁶⁴ most continue to await the descent of the tablets describing the "criteria" but suspect that the criteria will probably include "thou shalt nots" limiting the use of *Kintner* associa-

59. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

60. Rev. Rul. 56-23, 1956-1 Cum. Bull. 598, which declared, in part: "A group of doctors who adopt the [business] form of an association in order to obtain the benefits of corporate status for purposes of section 401(a) of the Internal Revenue Code of 1954 is in substance a partnership for all purposes of the Internal Revenue Code. It follows that the doctor-members are employers and therefore not employees. Rev. Rul. 33, Part 2(a)(1), C.B. 1953-1, 267 at 269. Furthermore, any period of service as members of a prior partnership will not be credited as a period of employment for purposes of the above section. The contrary position expressed in the case of *United States v. Arthur R. Kintner et ex.*, 216 Fed. (2d) 418, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations."

61. 1957-2 Cum. Bull. 886.

62. E.g., Dolman, *New Tax and Retirement Benefits for Group Professional Practice*, 30 *Los Angeles B. Bull.* 259 (1955), where fifteen attributes and advantages are suggested in a tempting list.

63. Casey, *Tax Tested Compensation Forms*, § 21,208, *Institute of Business Planning* (1958) sets them forth in full with marginal comments, but without recommendation for specific applications.

64. Mackay, *Pension Plans and Associations Taxable as Corporations for Professional Persons*, 10 *Sw.L.J.* 281 (1956) reports that in a letter dated March 7, 1956 the Rulings Division had informed him that the Treasury intended Rev. Rul. 56-23 to apply to the rest of the professions, as well as doctors, unless they could in fact incorporate under state law.

tions to relatively large groups with more than nominal capital assets and investments, thereby affording individuals or small firms no tax relief whatever.

As in the case of Jenkins-Keogh, most professional men wish *Kintner* well. The fact remains that the federal legislative and administrative processes have not, however, smiled upon the professional practitioner to date. Even the apparent federal blessings of the new pseudo-corporation tax treatment now apparently available to small business corporations⁶⁵ will not be available to him unless steps are taken to permit practitioners of the professions to incorporate as a matter of new state law. Therefore, should not the profession consider its chances with the state legislatures? If Montana's law had permitted professional corporations, would the Treasury have forced Dr. Kintner and his associates to go to court even if they had not in fact incorporated?

The proposal for professional corporations does not conflict with the *Kintner* design. It tends to confirm it, broaden the area of coverage, and avoid the dark and bloody ground of consistent congressional defeats.

TAXES ON PROFESSIONAL CORPORATIONS

In whatever form accepted by the state legislatures, the professional corporation will ordinarily derive all or most of its income from personal services. Will this constitute "personal holding company income" within the meaning of section 543 of the Internal Revenue Code of 1954? If so, our professional corporation must, like *Kintner* associations, be sizeable since it is anticipated that in many cases 25 per cent or more of the outstanding stock would be owned by a practitioner who performs those services,⁶⁶ and that the small professional corporation might easily meet the other personal holding company tests of nature of gross income and ownership.⁶⁷ All undistributed personal holding company income⁶⁸ is taxed at 75 per cent of the first \$2,000 plus 85 per cent thereof in excess of \$2,000.⁶⁹ At these prices, professionals had best remain in the individual or partnership frying pan, unless they are members of a large firm or clinic.

Section 543 of the Internal Revenue Code of 1954 includes among

65. Int. Rev. Code of 1954, §§ 1371-77, added by § 64 of the Technical Amendments Act of 1958.

66. Int. Rev. Code of 1954, § 543(a)(5).

67. Int. Rev. Code of 1954, § 542(a) provides in part that a personal holding company means any corporation (with exceptions) with 80% or more of its gross income constituting personal holding company income as defined in § 543 and with 50% or more of its outstanding stock owned by not more than 5 persons. Ownership is defined by § 544 of the Int. Rev. Code of 1954.

68. This is defined in Int. Rev. Code of 1954, § 545.

69. Int. Rev. Code of 1954, § 541.

the various kinds of personal holding company income "Personal service contracts" which include:

(A) Amounts received under a contract under which the corporation 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; and (B) amounts received from the sale or other disposition of such a contract.⁷⁰

This language was unchanged by the Internal Revenue Code of 1954.⁷¹ The original Committee Report says the language means to encompass "someone, such as an actor or artist with more or less unique talents, [who] incorporates himself and draws a salary from the corporation. The corporation contracts out his services with a third party and the difference between the amount paid to the individual as salary and the amount received from the third party is accumulated by the corporation."⁷² The statute was originally adopted to penalize an entity which had been devised during the 1930's for the benefit of actors, cartoonists and the like.⁷³ In *General Management Corp.*,⁷⁴ the corporation was paid under a contract for rehabilitation of another company and this income was held to fall within this provision where the contract required the taxpayer's chief stockholder to act as comptroller of the other company. The clutch has also extended to a father-son incorporated insurance agency where the insurance company had not relinquished its right to name the father as the only one who could accept insurance risks under the agency contract in the name of the insurer.⁷⁵

To a one-man professional corporation, the personal holding company tax, if imposed, would be a disaster.⁷⁶ Since there is only one practitioner, how could he safely contend that the corporation and not the patient or client has the sole right to designate by name or description the person who is to perform the services under any particular contract of professional employment? Possibly, if the one-man professional corporation also employs one or more licensed practitioners who are not shareholders and whose earnings aggregate more than 20 per cent of

70. Int. Rev. Code of 1954, § 543(a)(5).

71. See Int. Rev. Code of 1939, § 502.

72. Report of the Joint Committee on Tax Evasion and Avoidance, H.R. Misc. Doc. No. 10126, 75th Cong., 1st Sess. 14 (1937). See note 81 infra.

73. 1 Rabkin & Johnson, Federal Income, Gift and Estate Taxes 1718 (1958).

74. 46 B.T.A. 738 (1942), aff'd, 135 F.2d 882 (7th Cir.), cert. denied, 320 U.S. 757 (1943).

75. Rev. Rul. 54-34, 1954-1 Cum. Bull. 175.

76. Treas. Reg. § 39.502-1. The power to disregard the corporate entity has been granted the taxing authorities most frequently in one-man corporations by the courts. See 1 RIA, Fed. Tax Coordinator, § D-1200 at 18,037 (1958).

the gross annual corporation income, the gross income test might prevent the surtax. If it is the corporation which is employed, and the practitioner is not designated by name, or may only be designated by the corporation, or if the non-shareholding employee or the one owning less than 25 per cent of the stock is designated by the client or patient, then the test is met.⁷⁷ The proposed Treasury Regulations cast faint light on the problem by stating that a four-man engineering corporation under a contract to perform personal engineering services would not suffer the penalty tax if it is the corporation and not one of its shareholders who is designated to perform the services in the contract.⁷⁸ The example apparently means that the four engineers each own 25 per cent of the outstanding stock. If the corporation assigns the work among the engineers, it is not personal holding company income.

In *Kintner*,⁷⁹ the personal holding company problem was not raised. Of the eight doctors, seven were senior members; the other was a junior member; none of them apparently had more than a 25 per cent interest. As an association, it was not exempt from personal holding company tax⁸⁰ since it met the tests for taxation as a corporation. The cases and services give us little more. Therefore, it seems advisable to add the requirement that the small professional corporation itself, like an incorporated general contractor, be licensed under state law, as well as its principal employees. Thus, our professional corporation can itself make its contract with the patient or client and in turn designate who is to perform the services, if it would avoid this pitfall or unless it is otherwise exempt. If these rules are adhered to, our professional corporation may be secure from personal holding company tax, since it would be indistinguishable from closely related personal service corporations which have hitherto escaped this disaster.⁸¹ In any event, it will be no more vulnerable to this attack than a *Kintner* association.

77. 1 RIA, Fed. Tax Coordinator, § E-2309, at 20,052 (1958).

78. Proposed Treas. Reg. § 1.543-1(b)(8)(iii) Example 3, 21 Fed. Reg. 8925 (1956).

79. See notes 59, 63, supra.

80. G.C.M. 19619, 1938-1 Cum. Bull. 225; Int. Rev. Code of 1954, § 7701(a)(3).

81. During the debates of the 75th Congress on the question of extending the provisions taxing personal holding company income to include "incorporated talents", Mr. Doughton, Chairman of the House Committee on Ways and Means, made the following statement: "This device is used by persons whose services are of such nature as to command large annual salaries, and is used particularly by screen stars, radio, and concert performers, artists and the like. Such a person organizes a corporation, the stock of which is held by himself or members of his family. The corporation then hires the individual at a yearly salary much less than that which can be secured for his services to a third party. The amount paid to such person by his corporation is sufficient for living expenses, and the difference between this sum and that secured from the third party is allowed to accumulate in the company free from the individual surtax which would have been paid had the income gone directly to its real owner." 81 Cong. Rec. 9019 [1937]. The

For the individual practitioner or small firm, the chief hope of relief from personal holding company tax at present exists in the failure of Congress to include income from personal services in the kind of personal holding company income which disqualifies a corporation from the right to elect to be taxed as a partnership or sole proprietorship under the provisions of section 1371 and following added by section 64 of the Technical Amendments Act of 1958 (the 'Small Business Bill') which became effective on September 2, 1958. Although the Treasury Regulations, when published, or later 'loophole' plugging, may dim or extinguish this hope, it now appears that a professional corporation could qualify in the great majority of cases as a 'small business corporation' (i.e., a domestic corporation with less than 11 individual or estate shareholders, none of whom is a nonresident alien and all of whom agree to the election, and which is not a member of an affiliated group of corporations tied to a common parent) under the new Internal Revenue Code provisions. After so electing, such a small business corporation's net income would be taxed to the shareholders as though it had been distributed to them as a dividend at the end of the corporation's taxable year. The small business corporation, so electing, will not be taxed on such net income *and*, at the same time, it may employ its shareholder-employees and deduct their salaries and the costs of contributions to qualified profit-sharing, pension and retirement plans, insurance (group life, accident and health, major medical) premiums, tax exempt sick pay, employee medical expenses,

Report of Hearings Before the House Committee on Ways and Means of the 75th Congress, 1st Session, revised, contains, on page 66, covering the hearing of August 9, 1937, the following statement by Arthur H. Kent, Assistant General Counsel of the Treasury Department, dealing with the limited scope of the proposed amendment in covering only amounts received from contracts under which personal services are rendered by a shareholder owning 25% or more of the value of outstanding stock: "If the proposal were not further restricted, there might be some hardship upon operating corporations engaged primarily in rendering personal services and which necessarily enter contracts to render such services, selecting such members of their staffs as they may desire to perform such services. Therefore, it is recommended that the proposed amendment be applicable only in cases where a third party has the right to designate who shall perform the services contracted for. In most cases such third party will naturally be the other party to the contract with the corporation for the services of the individual." A similar statement appears in the Report of the Committee on Ways and Means on the Revenue Bill of 1937, H.R. Rep. No. 1546, 75th Cong., 1st Session 5 (1937): "The provision that some third party must have the right to designate who shall perform the services contracted for, or that the person to perform the services must be designated in the contract, will prevent this rule from applying in general to operating corporations engaged primarily in rendering personal services and which necessarily enter contracts to render such services, selecting such member of their staff as they may desire to render such services. Thus, corporations which let out the services of architects, engineers and advertisers would not as a general rule be required to report such income as personal holding company income. It is believed that the proposed amendment will take care of the 'incorporated talent' loophole."

deferred compensation and like benefits to the same extent as a 'real' corporation, without danger from the personal holding company tax.⁸²

A second tax pitfall which the professional corporation must sidestep is the "accumulated earnings tax" of 27½ per cent upon the first \$100,000 of "accumulated taxable income," and 38½ per cent of the excess,⁸³ if the professional corporation successfully avoids the personal holding company tax. The two penalty taxes are mutually exclusive.⁸⁴ Moreover, earnings of \$100,000, after taxes, may be accumulated⁸⁵ before there is any danger of this penalty. Thereafter a credit is allowed for all earnings and profits of any subsequent taxable year retained for the reasonable needs of the corporation. Such "reasonable needs" of a professional corporation might include amortization or prepayment of a mortgage on the business premises;⁸⁶ payment of premiums on life insurance owned by the corporation on the lives of its "key men";⁸⁷ and for anticipated needs,⁸⁸ such as the retirement of shares or loans upon death or retirement of a shareholder.⁸⁹ In brief, the professional corporation must have particular protection, both in its statutory nature, form and requirements and in its operation, from penalty taxation of this sort.⁹⁰

82. In its special release of August 22, 1958, entitled "Partnership or Corporation under the 1958 Tax Law," Tax Research Institute comments, at page 28, as follows: "The pseudo-corporation is particularly attractive for an individual who is an independent contractor. These individuals were unable to use a corporate setup to get the fringe benefits because the corporation might then be treated as a personal holding company subject to a heavy tax. But as a pseudo-corporation this danger is removed but the benefits remain."

83. Int. Rev. Code of 1954, § 531. An additional problem may arise under the doctrine of *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957) if more than one professional corporation is formed for the benefit of a practitioner or group of practitioners resulting in the danger of loss of surtax exemption.

84. Int. Rev. Code of 1954, § 532(b)(1).

85. Int. Rev. Code of 1954, § 535(c)(1), as amended.

86. *Lion Clothing Co.*, 8 T.C. 1181 (1947).

87. *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951).

88. Int. Rev. Code of 1954, § 537; S. Rep. No. 1622, 83d Cong., 2d Sess. 69 (1954).

89. Note that we have suggested in item 7 of our outline of characteristics of a professional corporation (p. 361 *supra*) that it must redeem all of the shares of a retiring or deceased shareholder; see *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952). The regulations provide [Treas. Reg. § 39.102-3(a)]: "Undistributed income is properly accumulated . . . if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation." In *Pelton Steel Casting Co.*, 28 T.C. 153, *aff'd*, 251 F.2d 278 (7th Cir. 1958), an accumulation to redeem stock of an 80% shareholder was for the benefit of the shareholder rather than the corporation, could have been made even after a dividend payment, and involved no danger of sale to outsiders, therefore was held unreasonable.

90. Int. Rev. Code of 1954, § 533(b): "The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders."

If initial impressions of the small business corporation are confirmed by regulations and experience, it would seem that, once the \$100,000 level of accumulated earnings is reached, the professional corporation, with the consent of all of its shareholders, could then make a timely section 1372 election, and escape all danger of the tax on unreasonably accumulated earnings.

Finally, there is danger in a one-man professional corporation that, if the corporation is created solely for the purpose of reducing income tax, the Treasury Department may successfully disregard the entity, and tax him as an individual.⁹¹

Other tax problems of doing business in the corporate form which beset the close corporation in all fields of enterprise may be equally anticipated by the professional corporation. Juggling of transactions between the corporation and the stockholders may result in payments being treated as nondeductible dividends taxable to shareholders, capital transactions distorted, and the like.⁹² "Reasonableness" of compensation may be a persistent problem. The shadow of re-enactment of an excess profits tax hangs over all corporations, should a war or "incident" recur. Liquidations, redemptions and distributions equated to dividends are factors with which the professional corporation must cope. But, in all of these respects, professionals would be on familiar ground, sharing the lot of their commercial brethren, with an opportunity to share their corporate tax advantages.

CONCLUSION

The professional corporation may prove to be no bumblebee. The laws of physics cannot fairly be related to the laws of men and their institutions, except that both types of laws benefit men chiefly when studied and properly applied. Neither aid invention while blindly accepted.

Some years ago a not dissimilar inequity existed whereby fortunate residents of "community property" states had many federal income, estate and gift tax blessings arising from split ownership of earnings and property between spouses based upon state law. Some common-law states, impatient with the failure of Congress to eliminate this discrimination, attempted to change their property laws for the sole purpose of achieving the same preferential tax treatment. Their efforts were not lasting monuments, by and large, of state legislation. Their results were

91. *Commissioner v. Smith*, 136 F.2d 556 (2d Cir. 1943). But see *National Investors Corp. v. Hoey*, 144 F.2d 466 (2d Cir. 1944). The general principle is that a "mere figmentary agent . . . should be disregarded in the assessment of taxes." *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943).

92. 1 Rabkin & Johnson, *Federal Income, Gift and Estate Taxation* § 11.04, *Transactions between Stockholder and Corp.* at 1124-35 (1958).

splendid, however, from the standpoint of the citizens of all the common-law states; Congress granted the income splitting privileges of filing joint tax returns and the estate tax privileges embodied in the marital deduction. Substantial tax equality has been achieved and these transplanted community property laws of the venturesome states have quickly died in almost all instances.

The professional corporation, whether it elects to be taxed as 'real' or as a partnership or proprietorship, seems to offer professional persons, who derive substantially all of their income from personal services, varying degrees of tax shelter. Members of a large firm, with little or no risk of suffering personal holding company tax, might decide to organize and continue to operate and pay taxes as a 'real' corporation for so long as a tax on unreasonable accumulation of income is not a threat, and, perhaps, later make a section 1372 election. Single practitioners and smaller firms, after establishing fringe benefit plans to the extent available and appropriate, would probably cause their professional corporations so to elect from the outset and, perhaps, continue to hope for the passage of some form of Jenkins-Keogh bill. Even if the small business corporation tax privileges are taken away by Congress through subsequent legislation or by the Treasury through regulation, the professional corporation could provide substantial tax shelter for some. The *Kintner* device might draw new strength from the support of state law authorizing professionals to incorporate. If all of the ethical requirements of the professions can be met under properly drawn state professional corporation statutes or codes, the way could be swiftly made through sympathetic state legislatures for the creation of professional corporations. For a great many professionals in private practice, such professional corporations, as regulated by their professional governing bodies and state administrative agencies and as formed by them to set up their own retirement, insurance and business plans, may lighten the penalties which the graduated federal income tax has so long imposed upon the professional sole practitioner, partner and associate. At best, such a professional corporation could provide substantial federal tax equality among businessmen, professional men and other taxpaying citizens by direct and prompt action of the legislatures of the several states.

Lawyers, where they can, attempt to select the most favorable forum for their cause. Professional men, generally, might well seek to do likewise. Let them first consider the professional corporation, and, having filled it out with appropriate powers and attributes, disciplined it with proper limitations, and reduced it to legislation compatible with the corporation laws and constitutions of the several states, then let them support its creation by the state legislatures. Let them not overlook in the process their standards of ethics, duties to the public, or dangers from lay competition.