

# Quasi-Corporations Quasi-Employees and Quasi-Tax Relief for Professional Persons

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## QUASI-CORPORATIONS, QUASI-EMPLOYEES AND QUASI-TAX RELIEF FOR PROFESSIONAL PERSONS\*

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It has long been recognized that our federal income tax laws provide industry and society in general with many economic incentives. One such non-revenue producing concern of the tax laws has been to encourage the development of retirement income through pension and profit-sharing plans. Unfortunately and unrealistically the tax law provisions limited these benefits to employees. This tax favored group included not only the punch-card number with his blue-collar but also the white-on-white collar corporate executive. It did not include however, self-employed persons such as members of partnerships who were not employees in the traditional sense. Among those persons denied the tax benefits were many professionals who were prohibited from selecting or constructing a form of business association whereby they could achieve employee status. Consequently, they engaged in vigorous lobbying, spearheaded by the medical and legal profession, to procure legislation permitting self-employed persons to set aside tax-free contributions from current income toward building retirement funds.<sup>1</sup> After more than ten years in the congressional clearing house, there has finally emerged a watered-down and tight-fisted version of pension and profit-sharing tax relief in the form of the "Self-employed Individuals Tax Retirement Act of 1962,"

\* The meaning of "quasi" is not entirely clear. Webster says: "As if; as though; as it were; in a manner; in a certain sense or degree; seeming; seemingly . . . ." Ballentine adds: "relating to or having the character of." Among learned law professors of our acquaintance, we have heard: "I'm not sure what a 'quasi-something' is, but I do know what it is not. It is not the thing modified by 'quasi.'" Justice Jackson has stated that: "The mere retreat to the qualifying 'quasi' is implicit with confession that all recognized classifications have broken down . . . ." *FTC v. Ruberoid Co.*, 343 U.S. 470, 487-88 (1952) (dissenting opinion).

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<sup>1</sup> See Keogh, "Tax Equity for the Self-Employed," 47 A.B.A.J. 665 (1961); Rapp, "The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill," 14 Tax L. Rev. 55 (1958).

commonly known as "H.R.10."<sup>2</sup> In evaluating this new legislation and the other attempts of professionals to obtain tax relief, we have assumed that the intended basis of the retirement plan benefits in our federal income tax structure was neither to provide a loophole for high bracket taxpayers nor merely to increase retirement funds of low-scale wage earners. Instead the proper purpose was and is to reduce the tax differential and economic inequality between income earned through personal services and income attributed to capital wealth.<sup>3</sup> Accordingly, sole proprietors and partners, while not within the orthodox conception of "employees," are, nevertheless, included in the personal service group which was thought deserving of some tax equalization with the capital wealth class.

The benefits which the tax laws have made available to employees and employers operating under a qualified pension or profit-sharing plan include:

- (a) Treating contributions (within specified limits) by employers to a qualified plan as a deductible business expense;<sup>4</sup> even though the individual employee has no allocable vested interest in the funds so contributed;<sup>5</sup>
- (b) Not taxing the employees or their beneficiaries until the money is actually received, and giving certain lump sum withdrawals of the funds special capital gains treatment;<sup>6</sup>
- (c) Allowing the accumulated earnings of the trust or fund to be exempt from income tax, thereby producing a much larger fund for retirement purposes;<sup>7</sup>
- (d) Extending Federal Gift and Estate Tax exemptions to qualified retirement funds.<sup>8</sup>

As tax rates increased during the World War II period, professional persons became acutely aware of the tax benefits which high bracket cor-

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<sup>2</sup> Pub. L. No. 87-792, 87th Cong., 2d Sess. (Oct. 10, 1962). The provisions of HR-10 have been integrated with the regular pension and profit-sharing plan provisions of the Code. See Int. Rev. Code of 1954, §§ 401-05 [hereinafter cited as "IRC"]. The Commissioner of Internal Revenue has issued Proposed Regulations with regard to the newly enacted Self-Employed Individuals Tax Retirement Act (Proposed Treas. Reg. §§ 1.401-6 to -12 and 1.405-1 to -3, 28 Fed. Reg. 3401 (1963)), and proposed amendments to the regular pension and profit-sharing plan provisions which take into account the HR-10 provisions (Proposed Treas. Regs. §§ 1.401-1, 1.401-3 to -4, 28 Fed. Reg. 3401 (1963)). It is not the purpose of this paper to give a detailed analysis of all the provisions of HR-10 but merely to make some observations regarding its merits in comparison with the corporate plan.

<sup>3</sup> For a good synopsis of the status and economic effect of the retirement plan in the United States see, Tax Revision Compendium (Compendium of papers on Broadening the Tax Base) submitted to Committee on Ways and Means, Vol. 2, 1337-89 (1959). See discussion at notes 327-52 *infra*.

<sup>4</sup> IRC § 404.

<sup>5</sup> However, contributions must be irrevocably made to a fund which is for the exclusive benefit of the class included in the plan. (The vesting requirements of HR-10 are much more rigid. § 401(a)(7).)

<sup>6</sup> IRC § 402.

<sup>7</sup> IRC §§ 401, 501(a).

<sup>8</sup> IRC §§ 2039, 2517.

porate employees were receiving, and which they as self-employed persons were being denied. For example, an employee with a taxable income of \$35,000 per year (50% tax bracket for a married person; 65% for a single person) by diverting \$5,000 of this income each year to a qualified pension plan would have an immediate annual tax savings of \$2,500 per year (\$3,250 for a single person). In addition, his accumulated pension fund thirty years hence could in all likelihood produce \$100,000 to \$150,000 more than a normal after-tax dollar 4% investment would have produced.

Initially frustrated in their endeavor to obtain pension and profit-sharing plan tax benefits by direct legislation, several professional groups (including the legal profession) began to seek other means to eliminate this discrimination against the self-employed. One solution was to become an "employee"; but to be an employee one must have an employer. Moreover, a professional practitioner requires a special kind of employer, an evanescent one, who is there for tax purposes but disappears when professional services are rendered and earnings are distributed. The obvious candidate for this position is "that invisible, intangible, and artificial being, that mere legal entity," the corporation.<sup>9</sup> Although the corporate entity is available to many self-employed persons, most professional persons have been traditionally prohibited from practicing in corporate form. As was recently stated by a Judge of the Ohio Supreme Court, "[S]o far as members of the bar are concerned the idea of the practice of law within a corporate structure is an emotional thing. It is much like 'cats, olives and Roosevelt'; it is either enthusiastically embraced or resolutely rejected."<sup>10</sup>

Notwithstanding this long-standing prohibition against the use of the corporate entity for professional practice, a group of Montana doctors formed a medical "association" and succeeded in convincing a federal court<sup>11</sup> that they should be taxed as employees of a corporation, an association being within the definition of corporation under the Internal Revenue Code.<sup>12</sup> The eventual Treasury Department response to this case was to issue new regulations<sup>13</sup> defining an association as an organization possessing certain corporate characteristics under its state's laws. This in turn encouraged the professionals to seek state legislation permitting them

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<sup>9</sup> *Bank of the United States v. Deveaux*, 9 U.S. (5 Cranch) 61, 65 (1809) (Marshall, C.J.).

<sup>10</sup> *Ohio ex rel. Green v. Brown*, 173 Ohio St. 114, 115, 180 N.E.2d 157, 158 (1962).

<sup>11</sup> *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); See also *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

<sup>12</sup> IRC § 7701(a)(3).

<sup>13</sup> Treas. Reg. § 301.7701-2 to -11 (1963).

to acquire the necessary corporate characteristics. Several states have responded by authorizing the formation of professional corporations or associations.<sup>14</sup>

The enactment of the Self-Employed Individuals Tax Retirement Act of 1962 now raises the question as to whether or not the association device need be further pursued and developed. If practice in corporate form provides significantly more tax benefits than HR-10 there is a great likelihood that professional persons will prefer to follow that labyrinthine way to tax relief.<sup>15</sup> Alternatively, the professional partnerships might explore the idea of amending the definition of "partnership" for tax purposes to permit it to be consistently treated as an entity separate from the partners and its employees. While this approach will obviate the ethics problem of practicing a profession in corporate form, it will not help the "solo" practitioner who will still be searching for a formalistic "employer."

The first part of this paper will explore some of the significant factors of being taxed as a corporation, including a comparison of HR-10 with the corporate retirement plan, and other corporate and non-corporate tax consequences which are important to the professional person. The second part will deal with the problem of whether the newly authorized state professional associations and corporations can satisfy the tax regulations and be taxed as corporations, and at the same time avoid violating traditional concepts of ethics especially relating to the legal profession. Finally, we will examine some of the objections to tax relief through professional associations and corporations, and will explore the possibility of more desirable ways for the professional person to obtain fair and equal treatment under the tax laws. While our discussion relates primarily to the practice of law, much of it will also be applicable to other professions.

## I

### TAX CONSEQUENCES

#### A. *Pension and Profit-Sharing Plans: HR-10 v. Corporate Plans*

In order to evaluate HR-10 properly we must compare it with the bene-

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<sup>14</sup> See notes 148-54 *infra*.

<sup>15</sup> In addition to ethical considerations, some of the tax factors to be considered by professionals regarding the corporation are: the corporate rate structure, application of "Subchapter S" to professionals, accumulated earnings tax, personal holding company tax, tax accounting problems, possible capital gain treatment on accounts receivable upon withdrawal or termination, special problems of "buy and sell" agreements, the sick pay exclusion, the \$5,000 death benefit, deductibility of health and accident insurance premiums, possible loss of IRC § 1301 (bunched income) provision on large fees collected in one taxable year, state and local tax consequences, etc. It should be noted that HR-10 covers "solo" practitioners whereas the association and corporation statutes in many states require three or more persons. See detailed discussion, notes 71-143 *infra*.

fits available under the corporate retirement plan. A valid comparison should include at least the following observations:

1. *Who is covered?* The new law (effective for tax years ending after January 1, 1963) includes within the term "employee" an individual who has "net earnings from self-employment" for self-employment tax (social security) purposes. Section 1402 of the Code defines the phrase "net earnings from self-employment" as "gross income derived by an individual from any trade or business . . . less [any] deductions allowed . . . which are attributable to such trade or business," and in the case of a partner, as his distributive share of the partnership ordinary income. Since the objective of qualified retirement plans is to cover only *personal service* income, there is a further limitation that where income is derived from both capital investment and personal services (e.g. a grocery store, contractors, and stock brokerage firms) an amount not in excess of 30% of the net profits from such a trade or business or \$2,500 (whichever is the greater) shall be deemed to be net earnings from self-employment.<sup>16</sup>

Therefore, all unincorporated individuals who receive personal service income from a trade or business (professionals and farmers included) and who are covered by the self-employed persons version of federal social security are included in the group intended to be benefited. However, not all unincorporated persons who render personal service are included within the Self-Employment Tax provisions of the Code. For example, doctors of medicine, Christian Science practitioners, and certain ministers are excluded from the Tax on Self-Employment Income, yet, HR-10 expressly allows such persons (whether performing their services in individual or partnership form) to be included within the pension and profit-sharing plan provisions. On the other hand, those who perform "the functions of a public office" are not included within the Self-Employment Tax.<sup>17</sup> Since HR-10 makes no exception for this group (as it did for doctors and ministers), self-employed governmental officials are prohibited from making use of the before-tax dollar investment provisions of HR-10 to the extent of their public office income, and are left to their regular after-tax dollar investment in such public retirement plans as are available to them. One possible rationale for excluding

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<sup>16</sup> IRC §§ 401(c)(1)(2) and 911(b). The general Senate Finance Committee explanation of HR-10 states, "[T]he entire amount received by a self-employed individual as professional fees or commissions will be treated as earned income if the taxpayer is engaged in the practice of a profession, such as medicine or law, even though he employs assistants to perform part or all of the services, provided the patients or clients are those of the taxpayer and look to him as the person responsible for the services rendered." (Reprinted in 3 CCH 1963 Stand. Fed. Tax Rep. ¶ 2601.)

<sup>17</sup> IRC §§ 401, 1402(c)(1). See also IRC § 1402(a)(1) as to certain real estate dealers, and Treas. Reg. § 1.1402(c)-1(b) (1963) as to definition of "public office."

those who perform public office functions from the tax-sheltered benefits of HR-10 may be that most self-employed persons have only minimum retirement benefits in the form of social security, while many public office holders are covered by a more generous and adequate retirement program. Even under this reasoning, however, the fact remains that the amounts being contributed by or on behalf of these persons are subject to current taxation, thereby leaving a significantly smaller net investment and a resulting smaller fund for retirement purposes. It should be noted that public office holders who are deemed to be employees in the common-law sense could not be included under HR-10 in any event. The only retirement plan tax benefits that may accrue to this latter group of individuals are with regard to amounts contributed by their employers to a qualified employee plan.<sup>18</sup> Amounts contributed by the employees themselves are not subject to the favorable tax shelter.

If a self-employed person incorporated or formed an association treated as a corporation for federal tax purposes, his income would be classified as salary or dividends instead of net earnings from self-employment. For those whose income is derived solely from personal service, it would seem that only the amount withdrawn as reasonable salary would qualify for pension plan benefits, whereas amounts received as a dividend might be deemed income derived from capital (a conclusion not consistent with reality in a law partnership, for example), and thus not entitled to pension benefits. For those whose income is attributable to both capital wealth and personal service, the corporate tax structure might be more beneficial where a reasonable salary might end up being higher than the arbitrary 30% of earned income rule applicable under HR-10. The use of the corporate form requires a close tab on the corporate profits before the end of the year in order to withdraw the maximum salary for computation of the retirement plan contribution and in order to avoid the double tax penalty on corporate profits.<sup>19</sup> Although the non-corporate form of doing business avoids this "salary-dividend" dichotomy, there are still mechanical and accounting problems in determining the amount of net earnings for retirement plan contribution purposes.

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<sup>18</sup> The phrase "qualified employee plan" has a very technical meaning in the pension and profit-sharing plan area. As used in this article it is meant to include all tax-favored retirement plans including the employee annuity plans (IRC § 403) which are on an individual rather than on the usual group basis of the "qualified plan." Amounts contributed by the employer under the individual employee annuity plan are in many instances authorizations by the employee to withhold or divert part of his salary, thereby technically becoming employer contributions. Amounts actually contributed by employees are deductible under the tax laws of Great Britain and Canada. (See Tax Revision Compendium, *supra* note 3, at 1380.)

<sup>19</sup> The "Subchapter S Corporation" (IRC §§ 1371-77) could in some cases alleviate the double-tax problem. See notes 110-15 *infra*.

2. *Inclusion of Employees.* Since the primary objective in encouraging the creation of retirement plans is to cover as many members of the working class as possible, it is not surprising to find that before an owner or highly paid corporate executive or officer can take advantage of these provisions they must be made available to the ordinary employees of the organization. Section 401(a) (4), which is applicable to all corporate and employer plans, therefore requires that "the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

In conjunction with these non-discrimination requirements applicable to all pension and profit-sharing plans (including self-employed persons plans) the new law requires that in the case of self-employed individuals who own more than 10% (those designated as "owner-employees") of either the capital interest or the profits in an unincorporated trade or business or partnership the plan must include *all* employees who have been employed by that person for 3 or more years, with the exception of certain part-time and seasonal employees.<sup>20</sup> This requirement is more strict than the provisions applicable to corporations and other employers. The regular employee plans (hereinafter sometimes referred to as the "corporate plan") specifically allow under reasonable circumstances the exclusion of employees whose wages are under \$4,800 (the present social security maximum).<sup>21</sup> Corporate plans are also expressly allowed to exclude, under reasonable circumstances, all employees other than salaried or clerical employees, and employees who have been employed for less than 5 years. All of these exclusionary provisions are still subject to the non-discrimination requirements. A further restriction not present in the corporate plan is that amounts contributed for employees must be non-forfeitable.<sup>22</sup>

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<sup>20</sup> IRC § 401(d) (3). A part-time employee is one "whose customary employment is for not more than 20 hours in any one week. . . ." A seasonal employee is one "whose customary employment is for not more than . . . 5 months in any calendar year." IRC § 401(d) (3). The Proposed Treasury Regulations [§ 1.401-10(b), 28 Fed. Reg. 3401 (1963)] provide that past services rendered (including services rendered in pre-1963 years) may be taken into account for the purpose of eligibility to participate in the plan, but not for contributions for past years. In addition, self-employed individuals must place themselves within the same years of service eligibility rules as their common-law ordinary employees in order to have the plan qualify.

<sup>21</sup> IRC § 401(a) (5). HR-10 permits coordination or integration of the retirement plan contributions with social security contributions if the contributions for the owner-employees do not exceed 1/3 of the total contributions. IRC § 401(d) (6) (A). However, those who earn under \$4800 cannot be completely excluded from the plan if they have been employed for 3 years or more. See Proposed Treas. Reg. § 1.401-12(h), 28 Fed. Reg. 3401 (1963).

<sup>22</sup> IRC §§ 401(a) (7), 401(d) (2). An amendment to the Code (made concurrently with the enactment of HR-10) applicable to all trustee pension plans requires that where a forfeiture does occur it cannot be applied to the benefit any employee would otherwise receive under the plan (IRC § 401(a) (8)). The Proposed Treas. Reg. § 1.401-7, 28 Fed. Reg.



While it is true that self-employed persons are not granted the greater flexibility allowed to corporate plans in the inclusion of employees, many self-employed individuals may find the cost of including their employees in the plan less than appears from a surface analysis. In evaluating the total cost of including employees, the self-employed will be well advised first to calculate his own tax savings that would result if such a plan were instituted. The requirement that all full-time employees with three or more years of service be included in the self-employed individuals retirement plan does not apply to situations where no one person owns more than 10% of the capital or profits of the business involved. Therefore, a law partnership with 10 partners each owning a 10% interest (i.e., self-employed employees but not owner-employees) would not be required to include automatically all employees with three or more years of service, but presumably they would still be bound to the less strict non-discrimination rules applicable to corporate plans. In other words, where the ownership interest is vested in several people the organization more nearly resembles the traditional corporate organization where, theoretically at least, owners and employees are separate entities for the most part. This is not true in an organization which renders solely personal service, such as a law firm, a medical clinic, and the like. The basic inequity in this area is clearly revealed when we look to the one man or closely-held corporation which is still allowed the more favorable treatment under the corporate retirement plan, despite the efforts of the Treasury Department and others to put this group of taxpayers on a par with self-employed individuals.<sup>23</sup> The desire of the Treasury Department to put closely-held corporations on a par with unincorporated entities, and the desire of the self-employed individual for corporate tax treatment has culminated in the compromise known as HR-10.

Where a self-employed individual who owns more than 10% interest (an owner-employee) in one business also owns more than a 50% interest in another unincorporated business, he is required to provide retirement plan benefits for the employees of each such trade or business "which (benefits) are not less favorable than contributions and benefits provided for [the] owner-employee" himself.<sup>24</sup> Consequently, if T is a one-third partner

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3401 (1963) provides that the forfeited amount must be used to reduce the employer's contributions under the plan. Proposed Treas. Reg. § 1.401-12(g), 28 Fed. Reg. 3401 (1963) sets forth an instance where contributions by self-employed individuals might have to remain forfeitable to comply with the nondiscrimination requirements. Also see Proposed Treas. Reg. 1.401-4(c), 28 Fed. Reg. 3401 (1963).

<sup>23</sup> See note 111 *infra* and accompanying text.

<sup>24</sup> IRC §§ 401(d)(9)(B), 401(d)(10). This situation should be distinguished from the case of a self-employed individual who is himself currently participating in a corporate retirement plan elsewhere. The Proposed Treas. Reg. § 1.401-10(b)(3)(ii), 28 Fed. Reg. 3401 (1963) indicates that such an individual would be allowed to participate fully in a

in the law firm of T, U & V, and T is also a 50% owner of the TY Company, a partnership, unless the employees of TY Company who have 3 or more years of service are included under a qualified pension or profit-sharing plan of that company, and unless the plan of that company provides benefits which are no less favorable than those provided for T under the plan of T, U & V, T is precluded from participating in the plan of T, U & V. Presumably the benefits to the employees of TY Company to be no less favorable must be based on, for example, the same percentage of earnings rather than the actual amount of the contribution made on T's behalf. If T were able to incorporate the TY Company he could apparently avoid the above mentioned restriction.

The requirement of including employees of other businesses is consistent with the basic objective of retirement plans in the federal tax law. In the case of the self-employed individual it prevents the creation of two or more businesses in order to attempt to segregate the employees from the employer. But where a self-employed person has two or more bona fide businesses, each with its own legitimate employees, he is treated much less favorably than he would be if he were to operate in corporate form. The Internal Revenue Code provisions applicable to corporate retirement plans do not contain a requirement that stockholders who own a controlling interest in another business be required to provide a retirement plan for the employees of the other business, and this is true even where the corporation is owned by only one stockholder. Furthermore, where a self-employed individual finds himself in the position of being unable to incorporate either or both of his businesses, he might well find himself in the dilemma of putting pressures on his associates in Partnership B to establish a retirement plan, while at the same time trying to convince his associates in Partnership A to postpone the establishment of a plan in Partnership A until he can get one established in Partnership B in order that he may participate in the Partnership A plan, etc., etc.<sup>25</sup> Where a self-employed individual has an existing plan under prior law covering only his employees, he may either adapt that plan to the requirements of the new law in order that he may be covered, or he may abolish the old employees plan and establish an entirely new one cover-

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self-employed individuals' plan even though he is benefited as a common-law employee under a corporate plan. Of course, on the corporate level a stockholder-employee is generally allowed to participate in as many corporate plans as he is able to.

<sup>25</sup> Problems may develop as to how much will be contributed toward his plan in each of these partnerships when we take into account the fact that his maximum contribution and deduction must be aggregated. Further difficulties may be encountered with regard to equalizing the contribution among the partners. The provisions of IRC § 401(d)(4)(A) require the consent of an owner-employee. But the plan can still be made available to the consenting partners.

ing himself and his employees, depending on the relative costs and merits of each one of these alternatives.

3. *Maximum Contribution and Deduction.* Undoubtedly, the most severe limitations imposed upon self-employed individuals by HR-10 are those relating to the maximum amounts that may be set aside for retirement purposes. The general rule is that an owner-employee can contribute no more than 10% of his earned income for his taxable year or \$2500, whichever is the lesser amount. The self-employed individual who is not an owner-employee (i.e., one who owns 10% or less) is not subject to this 10%—\$2500 maximum. The amounts contributed on behalf of any self-employed individual (including non owner-employees) however must comply with the provisions relating to non-discrimination in favor of highly paid employees.<sup>26</sup> Therefore, even though the plan can provide for a contribution of more than 10% of the non owner-employee's earned income, if this rate of contribution is higher than the rate contributed for the ordinary (i.e. the non-partner) employee, then the plan might be deemed discriminatory and thus ineffective for tax purposes.

Although there are some exceptions<sup>27</sup> to the 10%—\$2500 maximum contribution rule on owner-employees, all of the concern over maximum contributions is immediately rendered nugatory by the real curve ball in HR-10—the provision which limits the ultimate benefit to be obtained in any one year to 50% of the maximum contribution or \$1250, whichever is the lesser amount.<sup>28</sup> This maximum *deduction* is applicable to all self-employed persons, whether owner-employees or not. The foregoing might best be explained by the following example: The law partnership of A, B, C & D contributes 10% of each partner's share of earned income to a retirement plan. The total partnership profit is \$100,000. A owns a 50% interest, B a 25% interest, C a 15% interest, and D a 10% interest. Since A, B, and C own more than a 10% interest, they are owner-employees and as such their contributions cannot exceed \$2500 per year. The amount of the contribution on D's behalf however, is not so limited because he is not an owner-employee. The maximum contribution that may be made on A's behalf is 10% of \$50,000 (his share of the partnership profits) or \$2500, whichever is the lesser amount. Since \$2500 is less than \$5000, his maximum contribution is \$2500. Of this \$2500, however, he can only deduct (i.e., exclude from his current income tax) 50% or \$1250. The maximum contribution for B and C is \$2500 and \$1500

<sup>26</sup> IRC §§ 401(a)(4), 401(d).

<sup>27</sup> IRC § 401(e). There are certain penalties for excess contributions. Excess contributions are allowed on annuity, life insurance, and endowment contracts and certain medical and sickness plans as well as on the new series U.S. Bonds.

<sup>28</sup> IRC §§ 404(a), 404(a)(10), 404(e).

respectively. The maximum deduction for B and C is \$1250 and \$750 respectively. There is no limit on the amount that can be contributed on D's behalf. It is unlikely, however, that the senior partners will contribute more than 10% of D's share of the profits since they themselves cannot exceed that figure. If D received a salary as an employee over and above his 10% share of profits, his contribution could be based on both his salary and the 10% interest. If D did not have a regular salary in this case, the maximum contribution on his behalf would be \$1000 (10%  $\times$  \$10,000), but since he is a self-employed person, only 50% or \$500 would be excluded from his income for federal tax purposes.<sup>29</sup>

It becomes apparent that not only can you do more for your employees than you can for yourself under HR-10, but in addition a senior partner with the highest share of partnership income is in effect relegated to the same pension benefits available to those partners owning much less of the partnership interest than he does. In the example set forth above, A, a 50% partner, is limited to the same maximum contribution and deduction applicable to B, a 25% partner. This will no doubt seriously impair the mass implementation of retirement plans in many partnerships.

The severity of these limitations becomes annoyingly clear when we compare the contribution-deduction restriction of HR-10 with the corporate plan. Generally speaking, contributions to a corporate plan are limited to the amount that is actuarially reasonably necessary to provide for retirement benefits of the corporate employee including contribution credit for past service. In the case of a pension plan there is a 5% minimum but no dollar maximum. In the case of a profit-sharing plan the maximum is generally 15% of compensation paid, and in the case of a combination pension and profit-sharing plan the maximum is 25% of compensation paid.<sup>30</sup> There is no overall dollar maximum comparable to the \$2500 overall contribution maximum under HR-10. Above all, the amounts contributed under a corporate plan are not subject to the 50% of the amount contributed deduction limitation. The corporate plan is allowed to carry over excess contributions to succeeding years in which the contribution is under the maximum.<sup>31</sup> There is no such carry-over provision available to self-employed persons under HR-10. Relating this to our prior hypothetical, if our law firm of A, B, C & D were allowed to incorporate, partner A with \$50,000 of compensation would be allowed to *contribute and deduct* from his current income under a profit-sharing

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<sup>29</sup> If D were covered by a regular employee plan prior to the adoption of HR-10, there is a possibility that he might not be restricted to the maximum contribution and deduction rule of HR-10.

<sup>30</sup> IRC § 404.

<sup>31</sup> IRC § 404(a)(1)(D).

plan 15% of his compensation or \$7500. Under a partnership plan pursuant to HR-10 he is allowed to deduct only \$1250 (no matter how much he contributes) or a difference of \$6250. Assuming that A is in the 60% tax bracket the ultimate tax differential between HR-10 and the corporate plan is \$3750 per year. Where his effective maximum contribution rate is 15% under a corporate plan, A's effective rate under HR-10 is 2.5%.

Of course it should be noted that the one half of the contribution that is not deductible under HR-10 (i.e., the other \$1250 in partner A's case in the above example) although subject to the current tax and therefore an after-tax dollar investment, is insulated from the federal income tax during the period that it is invested for retirement purposes. Therefore the accumulated income on these contributions is tax-free while it is in a qualified type of investment. This feature should not be overlooked in evaluating HR-10, but the fact that ordinary annuities and life insurance contracts, for example, are also available as a tax shelter for accumulated income without complying with the rigors and expense of establishing a retirement plan makes this factor much less significant in light of the other severe restrictions in HR-10.<sup>32</sup>

It should be obvious at this point that those who formidably opposed the extension of pension benefits to self-employed individuals on the questionable theory that it would grant tax relief to those who need it least have won a stunning victory despite the formal enactment of HR-10. The original versions of HR-10 set an upward limit on contributions and deductions at a more realistic figure of \$7500. It was not until the final hours of debate on the floor of the Senate that the 50% deduction found any substantial support. The prospects of losing some \$350 million in revenue each year did not appeal to the Treasury watch dogs, although losses of much more than that have been overlooked and considered worthwhile for many other pieces of legislation. By the time the Senate got through amending HR-10, their estimate of the loss of revenue dropped to \$35 million per year.<sup>33</sup>

Although we may be able to see the relationship between the \$2500 maximum contribution and the government's concern over loss of revenue, it is much more difficult to understand the policy behind the further limitation of deducting only 50% of the amount contributed, with a maximum of \$1250. The purported rationale behind this latter restriction is reflected in the hearings held before the House Committee on Ways and

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<sup>32</sup> See IRC § 805.

<sup>33</sup> Britain and Canada experienced a revenue loss of about 1/6 of advance estimates. See Tax Revision Compendium, *supra* note 3, at 1367.

Means and in a letter to Chairman Byrd of the Senate Finance Committee from a John K. Dyer, Jr., a Philadelphia lawyer and pension consultant (undoubtedly covered by some corporate plan).<sup>34</sup> The reasoning goes something like this: since *employee* contributions to corporate plans are not deductible, and since there are many corporate plans in which the *employee's* contributions are somewhere in the neighborhood of 50% of the total contributions, an equitable approximation or practical compromise in extending retirement plans to self-employed persons would be in effect to treat the self-employed person as "half employer and half employee—a result not inconsistent with reality."<sup>35</sup>

This is, of course, a convenient philosophy for halving the balance of the revenue loss, and therefore becomes an acceptable argument for those who have their eyes on the Treasury coffers. But for those who are objectively searching for some sort of tax justice this reasoning is fallacious in at least two respects. First, the assumption that the employer and employee are separate entities is entirely unrealistic in the closely-held corporation.<sup>36</sup> One would have to be totally naive not to recognize that the employer and employee are for all practical purposes one and the same animal standing in the indelible corporate cage. Certainly even the highly paid corporate executive in the larger corporation is more realistically an employer and an employee all wrapped up in one. When a self-employed individual contributes 10% of his partnership profits to a retirement plan, how different is that from a contribution by a corporation on behalf of its sole stockholder? The corporate "salary" to its "owner-managers" is in substance no different from a self-employed person's share of net profits. While it is true that a "salary" must be reasonably related to the services rendered, and thus limited to some extent, with regard to personal service taxpayers the self-employed person's share of net profit would in most every case parallel what would be a salary for reasonable services rendered.

A second fallacy in the above reasoning is based on the conclusion that since many corporate plans have "employee" contributions of 50% of the total, the self-employed person should be treated as contributing one half as employer and one half as employee. This may be true of *many* plans, but it certainly is not true of most corporate plans. In fact, at the House Ways and Means Committee hearings in 1959 reliable evidence was produced to show that annual contributions to private pension plans

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<sup>34</sup> Tax Revision Compendium, *supra* note 3, at 1368, 1381.

<sup>35</sup> *Id.* at 1368.

<sup>36</sup> Stockholder-employees of closely-held corporations have been allowed to create retirement plans for themselves (even in a one or two-man corporation). See Rev. Rul. 157, part 4(a), 1961-2 Cum. Bull. 67; Rev. Rul. 81, 1955-1 Cum. Bull. 392.

in 1958 amounted to approximately \$4.7 billion with employees contributing only \$0.7 billion or less than 15% of the total amount.<sup>37</sup> In addition, the bulk of these employee contributions were made through plans of the nation's largest corporations.

Some members of the Senate Finance Committee who were behind this 50% deduction limitation recognized this fundamental inequity between corporate plans and HR-10 by proposing that this same 50% limitation be placed on a person who owns 10% or more of the stock of the corporation that employs him. This proposal was quickly defeated when it was brought to the Senate's attention that this would have an adverse effect on the entire private pension system in the United States.<sup>38</sup> When we are reminded of the fact that the principal purpose of the pension plan in this country is to equalize the tax burden for those who render personal services, it is not unfair to ask why all contributions to all retirement plans, public and private, employee funded or employer funded, should not be allowed a current tax deduction. However, until such a change is made in the basic retirement plan tax structure, the self-employed person is surely entitled to more realistic treatment on contributions to pension or profit-sharing plans.

4. *Methods of Funding.* Although there are various vehicles that can be used to fund these retirement benefits, all of them require a "plan." The Code does not define the word "plan;" however, the Proposed Treasury Regulations on HR-10<sup>39</sup> confirm the view that the plan be a definite written program setting forth all the essential details. Generally speaking there are five methods of funding HR-10 type plans:

- (a) Trusteed plans
- (b) Annuity plans
- (c) Bank Custodial Accounts
- (d) New Series of U.S. Treasury Bonds
- (e) Face Amount Certificates of Investment Company.<sup>40</sup>

In order to guarantee the tax exempt nature of the accumulated income on amounts set aside for retirement purposes, the creation of a formal legal trust according to local law is often used as a funding vehicle. In the ordinary corporate plan the trustee can be almost anyone. Under HR-10 however, where a trust is used, the trustee must be a bank, unless all of the self-employed individuals covered under the plan own less than

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<sup>37</sup> Tax Revision Compendium, *supra* note 3, at 1347.

<sup>38</sup> See HR-10 as passed by Senate on Sept. 7, 1962, §§ (2)(2), (3).

<sup>39</sup> Proposed Treas. Reg. § 1.401-12(b)(2), 28 Fed. Reg. 3401 (1963). See also recent ruling on corporate plans providing for generally the same requirement. Rev. Rul. 157, 1961-2 Cum. Bull. 67.

<sup>40</sup> IRC §§ 401(a), 401(f), 403(a), 404(d), 405.

an 11% interest in the particular trade or business involved. A trustee need not be a bank where the trust uses annuities, life insurance contracts, or endowment contracts of a life insurance company as a sole means of investment.<sup>41</sup>

Requiring a bank as trustee for unincorporated businesses with one or more owner-employees is obviously intended to keep a tighter control over the funds of the small firms. But it is these same small firms that are undoubtedly going to be hard put to justify a professional trustee's fee for a comparatively limited tax benefit. The result will be to shift a substantial part of retirement contributions to the life insurance company annuity contract. Although contributions can be made for life insurance contracts, these amounts are merely allowed as contributions to the plan (even over the \$2500 amount) but are not taken into account in calculating any part of the deduction. Since the objective of the retirement plan is to provide retirement rather than death benefits, any contributions applicable to life insurance contracts as distinguished from annuity contracts will presumably be allowable contributions only if they are merely incidental to the entire plan.<sup>42</sup>

Instead of using the trust plan as a method of funding, self-employed persons may purchase non-transferable annuity contracts directly from an insurance company.<sup>43</sup> HR-10 introduces at least two new funding devices for self-employed persons. One is the bank custodial account (with a bank as custodian) where the investments are made solely in certain mutual funds or annuity contracts. This device eliminates the requirement of creating a formal trust, but the custodian agreement will undoubtedly require draftsmanship in order to have the fund qualify for tax benefits.<sup>44</sup> The second type of new investment created by HR-10 is a new series of U.S. Treasury Bonds to be issued for direct purpose by employers for their employees including the self-employed persons themselves. The maximum contribution rules do not apply to this type of investment, but only the lesser of 50% or \$1250 of the amount contributed will be deductible. The apparent reason for allowing an un-

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<sup>41</sup> IRC § 401(d)(1). The Proposed Treas. Reg. provide an exception to the requirement of having a bank as trustee where a self-employed person had a qualified trust for his ordinary employees prior to October 10, 1962, even though the trust is amended after that date to include owner-employees [§ 1.401-12(c)(1), 28 Fed. Reg. 3401 (1963)].

<sup>42</sup> IRC § 401(e)(1). The Proposed Treas. Reg. incorporate the existing rule for corporate plans that life insurance protection can be included in the plan if it is incidental, without defining what is meant by incidental [§§ 1.401-12(c)(4)(i)(2), (ii), 28 Fed. Reg. 3401 (1963)]. For a related ruling under the corporate plan, see Rev. Rul. 67, 1954-1 Cum. Bul. 149.

<sup>43</sup> The Proposed Treas. Reg. provide that the proceeds from such annuity contracts must be payable directly to the employee or his beneficiary [§ 1.401-12(c)(4)(ii), 28 Fed. Reg. 3401 (1963)].

<sup>44</sup> See Proposed Treas. Reg. § 1.401-12(c)(5), 28 Fed. Reg. 3401 (1963).



limited investment in this new bond is the fact that such bonds may also be purchased by other persons without the tax deduction benefit. The bond itself will have restrictions as to withdrawal, deferral of interest payments until retirement, non-transferability, and redemption no earlier than age 59½ or earlier death or disability.<sup>45</sup>

The methods of funding available under HR-10 are not unduly restrictive and closely resemble the funding vehicles allowed corporate plans. Corporations are allowed in some instances to invest the contributions to the qualified trust in the corporation's own capital stock or securities. The fact that this investment technique may not be available to self-employed individuals should not of itself cause too much concern, especially among those who derive their income solely from personal services rather than from capital. About the only real objectionable feature in the funding area is the requirement to have a bank as trustee where a trust or custodial plan rather than an annuity plan is used. We can sympathize with the concern of the Treasury over the policing of these small business plans; but here again, is the incorporated grocery store or gasoline station any easier to police than the same business in unincorporated form?

Once you decide on the particular funding vehicle (i.e., ordinary trust investments, annuity contracts, bonds, etc.) a very important decision must be made as to the measuring rod to be used for computing annual contributions or investments. Should it be based on a predetermined fixed amount or formula (a pension plan) or should the contribution fluctuate with the annual net profit (a profit-sharing plan)? Since self-employed persons who are also "owner-employees" are already subject to special limitations on the amounts they contribute to their retirement plans, the requirement of a definite predetermined formula for computing contributions applies only to self-employed persons who own less than an 11% interest and to contributions on behalf of ordinary employees required to be covered by the plan. However, this must be read in conjunction with the non-discrimination provisions so that the contributions on behalf of "owner-employees" do not reflect favoritism to highly paid employees.<sup>46</sup>

The profit-sharing plan is the most flexible plan for most self-employed persons, especially professional individuals with fluctuating incomes.<sup>47</sup>

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<sup>45</sup> IRC § 405. The bonds will bear interest at 3-3/4% per annum. See Treas. Reg. §§ 341.0-.15 (1963) adopted as part of Public Debt Series No. 1-63, and Proposed Treas. Reg. §§ 1.405-1 to -3, 28 Fed. Reg. 3401 (1963).

<sup>46</sup> Note 22 *supra*.

<sup>47</sup> However, where the self-employed is too old to build up a reasonable retirement fund under the 15% profit-sharing plan limitation, the pension plan in some cases may provide a higher effective annual maximum contribution.

HR-10 does not expressly answer the question whether or not the self-employed plan can pick and choose its contribution years. The Proposed Treasury Regulations, however, provide that the plan be permanent and have recurring and substantial contributions, thereby precluding sporadic contributions.<sup>48</sup> In order for the contribution to be deductible it must be made during the taxable year for which the deduction is sought. This requires a close watch on the net profits before the end of the taxable year—a task which will be burdensome for most self-employed persons. The fact that the carryover and past service contributions<sup>49</sup> provisions are not extended to self-employed persons will make the early profit calculation more essential to HR-10 individuals than to their corporate kinfolk.

It seems somewhat paradoxical that while the legal profession actively lobbied for the enactment of HR-10 and alternative state legislation permitting lawyers to form professional corporations and associations, the American Bar Association Committee on Professional Ethics in November 1961 was interpreting Canon 34 of the Canons of Ethics (prohibiting any division of fees for legal services with a non-lawyer) as precluding lawyers from having a profit-sharing plan if non-lawyers be included as beneficiaries of the plan.<sup>50</sup> Although this interpretation is part of an overall opinion dealing with the ethical considerations of the practice of law in corporate or associate form, there is no indication that the Committee would change its views on the profit-sharing plan in the setting of HR-10.<sup>51</sup> Of course, lawyers who must include their non-lawyer employees in their retirement plan might have a pension plan for these employees and a profit-sharing plan for themselves, provided that they do not violate the non-discrimination provisions.<sup>52</sup> But how much difference in *substance* really exists between a contribution based on a

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<sup>48</sup> Proposed Treas. Reg. § 1.401-1(b)(2), 28 Fed. Reg. 3401 (1963). Compare the corporate plan requirements. Rev. Rul. 157, part 2, 1961-2 Cum. Bull. 67.

<sup>49</sup> See note 20 *supra*.

<sup>50</sup> ABA Comm. on Professional Ethics, Opinion 303 (1961), 48 A.B.A.J. 159, 161 (1962).

<sup>51</sup> The Proposed Treas. Reg. relating to plans covering self-employed individuals have adopted the ABA's interpretation of Canon 34 by providing that in the case of a trustee plan if applicable state law (quaere—does this include the Canons of Professional Ethics) bars fee-splitting between attorneys and nonattorneys, a profit-sharing plan covering both attorneys and nonattorneys will not qualify [§ 1.401-11(b)(2), 28 Fed. Reg. 3401 (1963)]. It should be noted that the ABA interpretation of Canon 34 (see note 50 *supra*) includes all profit-sharing plans and not just trustee plans, thereby precluding ethics-conscious lawyers from using this device even in a nontrustee annuity plan where the annuity proceeds must be made payable directly to the employee or his beneficiaries.

<sup>52</sup> In this connection, the Proposed Regulations state that where an owner-employee controls another unincorporated trade or business he cannot have a profit sharing plan covering his employees in one business and a pension plan in the other or vice-versa [§ 1.401-12(1)(1)(ii), 28 Fed. Reg. 3401 (1963)]. This same prohibition may very well carry over to self-employed persons who have only one business, and provide a different type of plan for their employees.

percentage of profits and a fixed contribution which can come from nowhere else but the net profits?<sup>53</sup> The embattled lawyer must not only seek refuge from the severe limitations of HR-10 imposed by his opponents from without, but before he can begin to fight for a more realistic Self-Employed Individuals Tax Retirement Act he must align the inconsistent forces from within.

5. *Taxation of Distributions from Plan.* The day of reckoning arrives when the benefits are paid to the participants of a qualified plan. The amount that remains to be taxed is that part of the annual contributions to the plan that were allowed as deductions (i.e., not taxed in prior years). For example, if T, a junior partner in a law firm were allowed to contribute \$5000 per year (assuming he was a non-owner employee not subject to the \$2500 maximum) for 20 years to a qualified plan for self-employed persons under HR-10, and if on his retirement at, say, age 65 his total accumulated interest was \$145,000 which was to be paid to him over his remaining life as an annuity, his tax consequences would be as follows: each year that the \$5000 was contributed on his behalf he would have been allowed to deduct only \$1250 ( $50\% \times \$2500$ ). Therefore, he should have been taxed on \$3750 for each year of the 20 year period, or a total of \$75,000. Thus, of the \$145,000 investment in his annuity, \$75,000 represents his prior taxed capital, and the remaining \$70,000 represents income to be taxed on a pro rata basis over the years he receives his annuity.

The chief advantages of having amounts taxed during the retirement years include:

- (a) the taxpayer is generally in a lower bracket;
- (b) double personal exemptions;
- (c) retirement income credit of \$1524 maximum per year;
- (d) no 3% medical limitation.

In many situations the first \$4000—\$4500 of retirement income can effectively escape any federal income tax. It is therefore possible that some of the income deferred from working years to retirement years will go untaxed.

This basic framework is applicable to corporate and self-employed persons retirement plans. At this point however, HR-10 diverges from the corporate plan and becomes subject to some rigid distribution requirements. For example, self-employed persons are penalized if they happen to consider themselves eligible for retirement before age  $59\frac{1}{2}$

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<sup>53</sup> See notes 200-07 *infra* and accompanying text.

(insurance age 60) or later than age  $70\frac{1}{2}$ .<sup>54</sup> If distribution is made before age  $59\frac{1}{2}$  other than for disability or death,<sup>55</sup> which are specially handled, the new law imposes a penalty tax of *not less than* 110% of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution.<sup>56</sup> This penalty tax is imposed only on the "owner-employee." Where a retirement plan is terminated for any reason and there is a distribution of the fund, the penalty tax would seem to apply even though the termination is due, for example, to a dissolution of a law partnership. Dissolving a law partnership would seem to be an extraordinary circumstance and not a purposeful effort to reduce the federal tax burden. Partnerships should make sure that death or withdrawal of a partner will not cause a termination of the partnership for retirement plan purposes before they embark on this elaborate endeavor.<sup>57</sup> A self-employed person (who is or once was an owner-employee) who happens to want to change firms is apparently covered by the penalty tax on any distributions received on his withdrawal from the firm. Can a withdrawing partner allow his vested funds to remain intact until he reaches  $59\frac{1}{2}$ ? Will this be deemed constructive receipt, thereby not escaping the penalty tax? Questions like these are going to confront the self-employed individual who comes within HR-10.

A further penalty imposed only on the "owner-employee" in case of premature distributions is a disqualification from participation in a retirement plan on his own behalf for 5 years following the year in which the distribution is made.<sup>58</sup> In connection with this penalty the new law provides that the plan itself will not be "qualified" unless the plan does not permit such premature distributions. Presumably, if the plan is silent on this point it could be asserted that the absence of this negative provision will cause the entire plan to be disapproved. It is therefore important to have the plan expressly incorporate all of the limitations and restrictions set forth in Section 401. In the event that there is a premature distribution, the Code provision disqualifying the distributee from participation in a retirement plan for 5 years apparently applies to participation in that particular plan and not in other plans created by other entities such as another law partnership.

The corporate plan has no predetermined retirement age dates, it has no penalty tax or other penalty for early withdrawal, and, in fact, if the withdrawal is due to the employee leaving the employ of the cor-

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<sup>54</sup> IRC §§ 401(a)(9), 401(d)(4)(B).

<sup>55</sup> Disability is defined in IRC § 213(g)(3).

<sup>56</sup> IRC § 72(m).

<sup>57</sup> IRC § 708; Proposed Treas. Reg. § 1.401-10(e)(2), 28 Fed. Reg. 3401 (1963).

<sup>58</sup> IRC § 401(d)(5)(c).

poration *before retirement*, the lump sum proceeds he receives are taxed at the more favorable capital gain rates. Capital gains treatment is not available to any lump sum distribution under HR-10 even if it is made during the specified retirement period. In place of the capital gains benefits HR-10 has created what may be deemed in some cases a reasonable facsimile in the form of a special averaging device.<sup>59</sup>

#### 6. *Some Special Problems.*

##### (a) *Professionals as employees.*

The Senate Finance Committee Report<sup>60</sup> makes it clear that HR-10 extends the definition of employee to *all* self-employed persons who were precluded from this sacred category under the common-law. The doctor or lawyer is technically not within the common-law definition of employee because of the great emphasis placed on the degree of supervision or control over the person involved. While HR-10 seems to eliminate this problem for professionals who cannot be controlled by a fictitious employer, if professional persons were to form associations and corporations would the same result obtain? Although it would be advisable to have a special ruling on this precise point, there is sufficient authority from the Internal Revenue Service and the courts for the proposition that lawyers and doctors will be deemed employees for pension and profit-sharing plan benefits.<sup>61</sup>

##### (b) *Must contributions to retirement plans be in cash?*

Under the corporate plan it has been held that the contributions to a retirement plan need not be in cash, and the fair market value of any property contributed will be the amount deductible.<sup>62</sup> However, the Proposed Regulations on plans covering self-employed owner-employees prohibit the contribution of property other than money to a *trusteed* plan.<sup>63</sup> More difficult problems arise on shifting pre-existing ordinary annuity contracts or life insurance contracts with a cash value to the nontrusteed retirement plan. Will these qualify for the contribution and/or the deduction? The Regulations are silent on this point. Some insurance companies might be able to provide more flexible conversion options in order that self-em-

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<sup>59</sup> IRC § 72(n).

<sup>60</sup> This report is reproduced in 3 CCH 1963 Stand. Fed. Tax Rep. ¶ 2601.

<sup>61</sup> *James v. Commissioner*, 25 T.C. 1296 (1956); Rev. Rul. 178, 1953-1 Cum. Bull. 404; also see special ruling, March 2, 1961, reprinted in 7 CCH 1961 Stand. Fed. Tax Rep. ¶ 6375 which held that an employer-employee relationship existed between a medical group and its doctor-members for social security and withholding tax purposes.

<sup>62</sup> *Colorado Nat'l Bank v. Commissioner*, 30 T.C. 933 (1958). However, promissory notes may not constitute "payment." *Wasatch Chem. Co. v. Commissioner*, 37 T.C. 817 (1962).

<sup>63</sup> Proposed Treas. Reg. § 1.401-12(k), 28 Fed. Reg. 3401 (1963).

ployed persons may utilize their past investments in an HR-10 plan.

(c) *Qualifying the retirement plan.*

There is no requirement that a pension or profit-sharing plan first be approved by the Internal Revenue Service before it will be given effect. However, there are several advantages in obtaining a favorable ruling from the Service before the plan is put into operation. First, it will guarantee the tax deduction for contributions to the plan; second, it will establish that the employees do not have to include the employer contribution in their gross income (within the specified limits); and third, it will serve as an assurance that the retirement fund will be exempt from Federal Income Tax on its accumulated earnings.

Although the Proposed Regulations say very little about the specific procedures to be followed in setting up a self-employed persons plan under HR-10, the Internal Revenue Service Guidelines on corporate plans<sup>64</sup> will probably be amended to include special HR-10 requirements.

(d) *Partnership agreements may need revision.*

Since the partner's distributive share of partnership income is affected by the partnership agreement, the agreement itself should be reviewed before HR-10 is implemented. For example, problems of allocation of depreciation, ownership rights, buy and sell provisions, tax year problems, etc. may need revision.

Over a decade ago professionals and other self-employed persons set out to convince Congress that they were entitled to and in need of retirement plan tax benefits. Some have hastily concluded that HR-10 places their progress at the half-way mark. Others have indicated a sense of satisfaction with HR-10 based on the philosophy that half a loaf is better than none. In our opinion, lawyers and other self-employed persons are nowhere near the half-way mark, and in fact may be in a worse position than they were a year or so ago. It may well be that HR-10 will temporarily take the heat off the Treasury for approval of the professional association or corporation. Where the corporate plan has an effective maximum rate of around 25% of compensation paid, the effective rate under HR-10 is less than 5% of net profits. In addition, the Federal Estate and Gift Tax exemptions,<sup>65</sup> the \$5000 death benefit,<sup>66</sup> and the

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<sup>64</sup> Rev. Rul. 157, 1961-2 Cum. Bull. 67; Rev. Proc. 12, 1956-1 Cum. Bull. 1029. There is a possibility that the Treasury will permit banks, insurance companies, and mutual funds to get a blanket approval for standard type HR-10 plans, thereby precluding the necessity of approving each and every plan.

<sup>65</sup> IRC §§ 2039, 2517.

<sup>66</sup> IRC § 101(b).

long-term capital gain benefit on lump sum distributions<sup>67</sup> applicable to corporate plans are not extended to self-employed persons.

In the past two years Congress has expanded the pension and profit-sharing concept to include employees of public educational institutions, giving them an effective rate of contribution of 16 $\frac{2}{3}$ % of salary plus liberal past service credits.<sup>68</sup> The Internal Revenue Service has recently ruled,<sup>69</sup> with regard to corporate plans, that past service with former employers may be used for the purpose of determining eligibility to participate in a retirement plan of a present employer. These past service benefits are not included within HR-10. At a time when Congress and the Treasury are liberalizing the pension and profit-sharing plan to include more and more taxpayers who render personal services, ten million or more self-employed persons are hamstrung by rigid requirements which may effectively eliminate not only many self-employed persons but many of their employees as well. Lawyers should give some thought to the following questions: How much longer are we going to close our eyes to the fact that the tax laws flagrantly (though subtly) discriminate against the self-employed and indeed all personal service income? Should members of the legal profession allow themselves to be called "half employer and half employee" for tax purposes? Should a profit-sharing plan be realistically deemed a fee-splitting device under Canon 34?<sup>70</sup> How different are self-employed persons from corporate executives and stockholders of closely held corporations, especially for tax purposes?

If the primary objective of the United States Government in encouraging the creation of retirement plans is to equalize the tax differential between personal service income and income from capital wealth, the Self-Employed Individuals Tax Retirement Act of 1962 is still far off course and quite deceptive—we suggest, "she is neither fish nor fowl nor good red herring."

#### *B. Some Comments on the Formation of a Professional Association Or Corporation*

Once we cast aside the Self-Employed Individuals Tax Retirement Act of 1962 as a patently inadequate retirement plan scheme for lawyers and other self-employed persons, we are again forced to consider the case for the professional association or corporation. The road to corporate tax treatment for the law firm is not easily traveled. It has many curves,

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<sup>67</sup> IRC § 401(a). Additional benefits available to corporate employees are stock options (IRC § 421) and deferred compensation contracts.

<sup>68</sup> IRC § 403(b).

<sup>69</sup> Rev. Rul. 62-139, 1962 Int. Rev. Bull. No. 34, at 16.

<sup>70</sup> See notes 200-07 *infra* and accompanying text.

detours, and roadblocks; and not all of them are clearly posted. Before we discuss the ethical, legal, and jurisprudential aspects of the corporate practice of law, the first logical inquiry is: is the trip worth taking?

If we focus our attention solely on the pension, profit-sharing, and stock-option plans available to corporations and their employees we are at once convinced that the journey into the corporate wonderland is well worth any effort it may take. But the federal tax structure is far too complex to permit an easy transition from the individual and partnership forms of doing business to the corporation or association without any serious tax consequences. The great temptation to acquire the more liberal retirement plan benefits available to certain entities taxed as corporations should not cause us to overlook the need to compare the entire partnership tax structure with the entire corporate tax structure before any intelligent decision can be made. This comparative analysis should include not only the different rate structures and other problems of everyday operation but, in addition, the tax consequences on formation and termination of the partnership and corporation. It may well be that the practice of law in corporate form would provide many significant tax benefits apart from the retirement plan. Likewise, we may find that certain features of the corporate tax structure will vitiate the potential benefits available under the retirement plan. Although there are undoubtedly a vast number of significant problems that need to be explored in this area, lawyers, doctors, and other persons who derive their income from personal service rather than from capital wealth have certain peculiar problems of their own.

One item that will undoubtedly cause some concern to professional firms is amounts to be collected from clients, sometimes referred to as "accounts receivable" or "unrealized receivables." Furthermore, the tax implications of this one asset are not limited to the problems of formation of a corporation. Accounts receivable will continue to be an important tax factor during the operation of the firm, and at its termination (by death or otherwise), and even beyond death into the estate of a deceased member of the firm. Under the general principles of federal income taxation, amounts to be collected from clients normally represent "income" and not capital or "property." If a solo practitioner or partnership decides to form an association or corporation pursuant to state law and the Treasury Regulations,<sup>71</sup> will there be a taxable event on the transfer of the accounts receivable and the other assets (including good will) to the new entity? If so, will the gain on the accounts receivable and the

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<sup>71</sup> Treas. Reg. § 301.7701-1 to -11 (1963); T.D. 6503 (1960); see part II of this paper, *infra* at 655.



good will be ordinary income or capital gain? In the case of a partnership, should the partnership first be liquidated and the partners make the transfers to the association or corporation, or should the partnership itself transfer its assets to the new entity and the partnership distribute the new entity's stock (if there is stock) or other ownership interest to its partners?

Section 351 of the Code in effect postpones recognition of any gain or loss on the transfer of *property* to a corporation in exchange for corporate stock or securities if the transferor or transferors control the corporation immediately after the exchange. The chief reason for this section is that although there has been a technical sale or exchange of property for stock, in reality it is merely a change in form (i.e., a transfer within the same economic unit from one pocket to another). The application of this section to the professional person raises several questions. First, does the word "property" include accounts receivable? Section 351 does not define "property" other than stating that "stock . . . issued for services shall not be considered as issued in return for property."<sup>72</sup> Section 1221 (4) expressly excludes from the definition of property for capital gain or loss purposes "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered . . ." It could be argued that since this express exception is not included in Section 351, and since the only exception is for services rendered, money due from clients is property and thus not taxable when transferred to the controlled corporation or association.<sup>73</sup> But it has been held<sup>74</sup> that the transfer of accounts receivable to shareholders in complete liquidation of a corporation was an anticipatory assignment of income and not a transfer of property even though the corporation liquidation sections<sup>75</sup> do not expressly exclude accounts receivable from the definition of property. Although transfers of accounts receivable to corporations must certainly be a frequent occurrence, there is very little authority on the taxability of such a transfer. However, what little authority there is seems to indicate that it will be treated as property for Section 351 purposes.<sup>76</sup> Treating the transfer as a taxable event to the transferors would not seem to be consistent with the policy underlying Section 351. Unlike the case where

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<sup>72</sup> IRC § 351(a).

<sup>73</sup> IRC § 317 defines "property" for certain corporate distribution purposes only.

<sup>74</sup> *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961); *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90 (2d Cir. 1957); cf. *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957).

<sup>75</sup> IRC §§ 331-37. However, the installment sales regulations (Treas. Reg. § 1.453-9 (1963)) specifically state that no gain or loss shall be recognized on the transfer of installment obligations in an IRC § 351 transfer.

<sup>76</sup> *P. A. Birren & Son, Inc. v. Commissioner*, 116 F.2d 718 (7th Cir. 1940).

services are rendered or to be rendered for the stock to be received from the corporation, the government can keep a closer tab on the accounts receivable by giving it a zero basis in the hands of the corporation.<sup>77</sup> On the other hand, where accounts receivable are distributed in complete liquidation of a corporation to various shareholders, different policy reasons might justify taxing the distributing corporation on the value of these receivables as an anticipatory assignment of income.

Although Section 351 might therefore apply to postponing recognition of gain on both ordinary income and capital gain types of transfers, it should be noted that once the accounts receivable get into the hands of the corporation or association, it is possible, at least with regard to some of the stockholders or associates, that their portion of the accounts receivable could be converted from ordinary income to capital gain by a sale of their stock or beneficial interest. Even though the corporation or association would be taxed on the receivables at the corporate ordinary income rates (in many cases lower than the individual rates), there is an opportunity to shift the ultimate tax burden over to a low bracket member. Whatever this flexibility is worth, it is not available to the partnership because of the so-called "collapsible partnership" provisions of Section 751. A partner who sells his interest in a partnership is normally selling an interest in a capital asset, except for unrealized receivables and certain inventory items. The sale of an interest in a corporation, on the other hand, is treated entirely as a sale of a capital asset, even though a portion of what is being sold is really an interest in receivables or other income items.

Once we conclude that accounts receivable can be property for Section 351 purposes, the next problem is the 80% control requirement.<sup>78</sup> Those who transfer "property" to the corporation must end up controlling 80% or more of the *stock* of the corporation. This, of course, guarantees the continuity of interest in the transferee corporation. But in addition to the usual problems applicable to this provision<sup>79</sup> lawyers and other professionals will have some problems of their own. Only a few of the state professional corporation and association statutes call for the issuance of shares of capital stock. In view of the 80% of stock requirement together with the provision that the transfer must be "*solely* in exchange for *stock* or *securities*" [emphasis added], if the statute were to be interpreted literally, then Section 351 would not apply to transfers to associations or

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<sup>77</sup> IRC § 362. IRC § 351(a) treats the issuance of stock for services as a taxable event at ordinary income rates. See note 83 *infra*.

<sup>78</sup> IRC § 368(c).

<sup>79</sup> See Bittker, *Federal Income Taxation of Corporations and Shareholders* 89 (1959).

professional corporations where no stock or other certificates are issued. Even though complying with the continuity of interest doctrine and the policy behind the 80% and solely for stock rules, professional persons, at least from the government's point of view, may be in a precarious position. The goal of Congress in defining an "association" as a corporation for tax purposes was not to extend corporate tax benefits to those who could not incorporate for state law purposes. Rather it was intended to prevent avoidance of the corporate double-tax burden by those who obtained all of the benefits of state corporation law without in fact organizing a corporation. Therefore, we are involved with a situation in which professional groups are not only using an indirect route to obtain tax relief, but, in addition, they are using a section of the Code that was enacted to produce an opposite result. In fact, up until 1954<sup>80</sup> of the litigation on the meaning of the term "association" for federal tax purposes involved taxpayers who were arguing that they were not an association. Therefore, any pre-1954 judicial or administrative authority dispensing with the requirement that "stock" be issued for Section 351 or any other corporate tax purpose might not be carried over to the professional association or corporation.<sup>81</sup> In other words, although the present regulations defining association do not require the issuance of stock in order to have general corporate tax treatment, the Internal Revenue Service could through very technical reasoning say that Section 351 is not applicable to professional associations without stock even though it is applicable to oil and gas lease associations where the joint operators do not receive stock. This same rationale could carry over to other situations where, for example, a sale of an interest in an association not represented by actual stock certificates results in the sale of a pro rata share of each association or corporation asset, thus precluding capital gains treatment on items such as accounts receivable.<sup>82</sup> In order to avoid this strict interpretation, the state statutes should provide for the issuance of shares of stock.

Further difficulties with regard to the 80% rule might arise where one or more members of the new entity do not contribute money or other property but instead receive a share of the association or corporation in return for services. For example, some state statutes require at least three associates; and A and B, who are operating a law partnership, might decide to transfer all of their assets (including receivables and appreciated property) to an association and give C a one-third interest. If C contrib-

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<sup>80</sup> *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

<sup>81</sup> For such a ruling with regard to an oil and gas lease association, see Special Ruling, January 11, 1949, reported in 5 CCH 1949 Stand. Fed. Tax Rep. ¶ 6061.

<sup>82</sup> E.g., *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

utes nothing but his future services, then C is immediately taxed on his one-third share as compensation (the new entity apparently gets a deduction), and A and B cannot use Section 351 because they own less than 80% of the association. Therefore, all of the gain on the property, including the value of the accounts receivable, is subject to current taxation with the receivables taxed at ordinary income rates. Perhaps it is possible to avoid some of these adverse consequences by either postponing C's ownership interest for two or three years, or by having A and B retain the receivables and/or other property in their own hands, whereby the income would be reported by them as received. However, both of these devices could be attacked as mere tax-avoidance schemes,<sup>83</sup> and could also have a further adverse effect on the association's or corporation's complying with the state statutes, the Treasury Regulations, and the pension plan provisions. It could be argued that since the partners are now operating as a new entity their services with regard to the collection of the accounts receivable (which may include the value of uncompleted work in the partnership) are really performed for the corporation, and thus the accounts receivable would be constructively transferred to the new entity. Indeed, the Commissioner may have authority to allocate income to the new entity by Sections 482 and 446. Of course, if C were able to raise sufficient cash or property to contribute enough to bring his share over 20%, then the 80% rule would be complied with and no gain or loss would be recognized under Section 351.<sup>84</sup>

If a transfer to a corporation or association does not comply with Section 351, the tax consequences for a lawyer could be so adverse as to warrant a decision to forget about the golden harvest of corporate pension plans and other corporate tax benefits. First of all, what is the value of the property transferred as compared with the basis of that property? If accounts receivable are included within the definition of "property," then what do the accounts receivable include? Will any good will be deemed to be transferred? If so, how will it be valued? Those lawyers and law firms who report their own income on the accrual basis (a rarity

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<sup>83</sup> For a discussion of transactions outside of IRC § 351 and the possibility of a "sale" unrelated to the "transfer," see, Paul & Kalish, "Transition from a Partnership to a Corporation," N.Y.U. 18th Inst. on Fed. Tax 639, 651 (1960); Bittker, *supra* note 79, at 102.

<sup>84</sup> In some instances lawyers may prefer the transfer to be treated as a taxable one in order to get a stepped-up basis on appreciated property for depreciation purposes. In this connection the new IRC § 1245 (pertaining to certain personal property), Rev. Rul. 92, 1962-1 Cum. Bull. 29 and *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958) (dealing with the loss of the depreciation deduction where the sale price exceeds the adjusted basis of the property) will have to be considered. Also IRC § 1239, regarding transfers by an individual (and by partnerships?) to a controlled corporation, may tax the transfer at ordinary income rather than at capital gain rates. On the other hand, where there are potential losses (i.e., high basis-low value properties), IRC § 267 may disallow such losses where the corporate entity is used.

in professional firms) would already have reported amounts billed or due as of the close of their last taxable year. Any of these accounts which would not have been collected at the time of their transfer to the new entity would result in no gain or loss at the time of the transfer and would have a basis in the hands of the corporation equivalent to the amount already taxed to the partnership or transferor. However, the property rights actually transferred to the professional association or corporation include more than the amounts presently due from clients. In fact, the Treasury Regulations covering the partnership provisions define unrealized receivables as including "services rendered or to be rendered, to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution."<sup>85</sup>

Under this broad definition all work in process, pending contingency litigation, and retainer contracts would have to be valued and included in the amount transferred.<sup>86</sup> While it is true that many law firms collect their fees on a comparatively current basis, many doctors and dentists have large amounts due on billed accounts receivable for a year or more, and therefore if Section 351 is not complied with they might experience an immediate tax on amounts which in the ordinary course of their business would not be collected in the current taxable year. On the other hand, law firms normally have significantly large amounts of contingent fees and other work in process which might not be realized and collected for some time to come. The valuation of the amounts to be collected for these services will often be difficult, but this factor will not prevent the taxation of these amounts at the time of formation of the new entity unless Section 351 is fully complied with.

The broad definition of unrealized receivables for partnership purposes raises the question of whether or not the same definition would carry over to non-partner or non-partnership transfers to professional associations or corporations. Certainly a solo practitioner or group of individuals

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<sup>85</sup> Treas. Reg. § 1.751-1(c)(ii) (1956).

<sup>86</sup> The Advisory Group on Subchapter K has proposed a change in the definition of unrealized receivables in IRC § 751(c) which would include all property which would result in ordinary income if sold at a gain. Advisory Group, Subcommittee on Internal Revenue Taxation of the Committee on Ways and Means Revised Report on Partners and Partnerships 41 (December 31, 1957).

who were not previously associated in the practice of law as partners would not be bound by the partnership provisions. But in the usual case the lawyers who form associations or corporations would bring with them not only their billed accounts receivable, but in addition any contract or property rights such as unbilled receivables, work in process, and retainer rights, which would have to be valued and taxed in the event that Section 351 does not apply. In the case of a partnership the partners will have to consider the question of whether they should have the partnership itself make the transfer to the new entity or whether the partnership should first be liquidated and the partner make the contribution of property directly to the new entity. In either case, the partnership would be deemed to be liquidated, and in most instances there would be no gain or loss to the partners or to the partnership no matter which route was followed. If the partnership distributed all of its assets to the partners in complete liquidation, the partners would merely take as their basis for the property distributed their pro rata share of the partnership basis for such property. However, where the total partnership basis for the property to be distributed differs from the partners' bases for their partnership interests, or where there have been disproportionate distributions of property to any of the partners, it might well make a difference to some partners whether or not the partnership or the partners make the contribution of property to the professional association or corporation.<sup>87</sup> As far as Section 351 is concerned, the transfer can be by the partners or by the partnership itself.<sup>88</sup>

Another item of property that could cause problems on the formation of a professional association or corporation is good will. Despite some ethical prohibition against professionals and especially lawyers being able to transfer good will,<sup>89</sup> it could be successfully argued that where a professional person forms a corporation or association he is transferring an element of good will to the new entity. If the transfer as a whole complies with Section 351, then no gain will be recognized as to the good will at that time. However, when the corporation or association is liquidated there will probably be a taxable gain with regard to the then existing good will.<sup>90</sup> Therefore, those who contemplate a trial period with the professional association or corporation and later find that they would rather operate in partnership form may find themselves paying a capital

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<sup>87</sup> See Jackson, Johnson, Surrey, Tenen & Warren, "The Internal Revenue Code of 1954: Partnerships," 54 Colum. L. Rev. 1183, 1228 (1954).

<sup>88</sup> Treas. Reg. § 1.351-1 (1955).

<sup>89</sup> See notes 275-84 *infra*.

<sup>90</sup> For a more complete discussion of the tax consequences on termination of a corporation and the nature of good will see note 129 *infra* and the accompanying text.

gains tax on something they never anticipated. One important observation with regard to good will is the different tax consequences of a sale or transfer of good will among partners in a partnership as compared to a transaction between stockholders or associates of a corporation or association. The partnership provisions allow the partnership agreement to determine the nature of gain on the sale or transfer of good will.<sup>91</sup> If the partnership agreement does not specify a payment for good will, the distribution to the retiring or deceased partner will be taxed as ordinary income (i.e., a distribution out of profits), whereas if the partnership agreement does call for a payment of good will the distributee partner is normally allowed to treat such payment as a capital distribution.<sup>92</sup> In most instances, therefore, the remaining partners would prefer to have the distribution treated as a pro rata distribution of profits, thereby lowering their share of ordinary income, while the retiring partner or a deceased partner's estate would normally prefer to have the distribution classified as a capital transaction. Although this does provide some flexibility in shifting the tax burdens to low-bracket partners, in most cases it results in give and take bargaining and some dissension among the partners. If law partnerships are allowed to transfer their good will to an entity which will be taxed as a corporation they will lose some of this flexibility, but they will for the most part assure each associate or stockholder capital gains treatment on amounts received for good will without the necessity of an agreement to that effect.

### *C. Other Transitional Problems*

The transfer of an existing law firm (either sole proprietorship or partnership) to a corporation or association may not be a taxable event where the requirements of Section 351 are met. But even though there is a mere change in form of conducting a law practice, there are serious tax accounting problems that may develop. First, there is the problem of allocation of income and deduction items to the proper entity. Next there is the problem of bunching income into an abnormally short period for tax return purposes. A further problem exists in the choice of a taxable year for the new entity.

If accounts receivable are deemed to be property for Section 351 purposes, and that section is otherwise complied with, then the income will be reported by the corporation or association as collected or as accrued if the new entity adopts the accrual method of reporting. But if

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<sup>91</sup> IRC § 736(b).

<sup>92</sup> See Tenen, "Tax Problems of Service Partnerships," N.Y.U. 16th Inst. on Fed. Tax 137 (1958).

the transfer of accounts receivable is not a "351 transfer," then the value of all the receivables will be taxed to the partners or individuals at the time of transfer unless the partners or solo practitioners can effectively retain ownership of these accounts until collected. The transfer of liabilities to the professional association or corporation raises the problem of whether or not payment by the corporation or association will be a deductible item for the new entity. Even where the transferor is on the cash basis there is some authority for allowing a deduction of the liability at the time of liquidation before actual payment was made.<sup>93</sup> However, because of the sparsity of precedent, items such as accrued wages, interest, rent, and taxes incurred by a law partnership, for example, should perhaps be paid by the partnership before final liquidation in order to insure the deductibility of the expense.

The time of the year at which partners choose to form a professional association or corporation demands serious consideration. For example, let us assume a partnership which has a January 31 fiscal year<sup>94</sup> winds up its affairs on September 30. The final partnership year would therefore close on September 30, and, assuming that all the partners were calendar year taxpayers, there would be a bunching of one and two-thirds years income in each partner's current calendar year.<sup>95</sup> The difference in the rate bracket applicable to this additional income being taxed in one year might in some cases wipe out the current tax advantages of a pension or profit-sharing plan or other sought-after corporate tax benefits.

The choice of a taxable year for a corporation or association is much less restrictive than in the case of partnerships formed after April 1, 1954. Section 706(b) provides that a partnership may not change to or adopt a taxable year other than that of its principal partners (5% or more) unless it establishes a business purpose to the satisfaction of the Commissioner. Since this rule is obviously impossible to follow in cases where the principal partners have different tax years, the partnership would probably have to be on a calendar year. In the case of corporations, however, the taxable year can be any twelve month period. This is another example of where the rules which are properly applicable to large corporations carry over to the closely-held corporation (including a Subchapter S Corporation) which in substance more nearly resembles a

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<sup>93</sup> *Colonial Enterprises, Inc. v. Commissioner*, 47 B.T.A. 518 (1942) (acq.). With regard to certain real property tax situations see IRC §§ 164(d), 461(c).

<sup>94</sup> The requirement of IRC § 706(b) that the partnership taxable year be the same as that of all its principal partners is not applicable to partnerships organized prior to 1954. (IRC § 771(b)).

<sup>95</sup> IRC § 706(a) requires the partner to include his share of the partnership income for any taxable year of the partnership ending within or with the taxable year of the partner.



partnership. At a time when future tax rate reductions are in the offing, the selection of a corporation or association fiscal year which will enable a deferral or postponement of tallying up with the government by calendar year associates or stockholders might be in order. However, there might be practical limitations on this flexibility in cases where salaries would have to be currently withdrawn in order to avoid the double-tax on corporate profits (where Subchapter S elections are not in force), or where the Subchapter S election is in force to protect the pension plan contribution which is based on actual salary withdrawn and not "constructive dividends."

#### *D. Some Comments on the Operation of a Professional Association or Corporation*

When law firms transform themselves into a corporate or association entity they are stepping into a maze of problems that bear constant consideration. Members of the firm will have little time for discussing such homey things as covenants running with the land, directed verdicts, statute of frauds; and instead they will be heard uttering (to themselves as well as to one another) phrases such as double-taxation, reasonable salaries, pension plans, personal holding company, Subchapter S Corporation, and tax avoidance purpose. Much has already been written on the tax consequences of operating a professional corporation.<sup>96</sup> However, some further observations are in order.

The problems of the corporate rate structure, taxes on personal holding companies, taxes on accumulated earnings, and the Subchapter S election to be taxed as individuals are all unimportant ones in a professional association or corporation where all of the income can be distributed currently in the form of "reasonable salaries"<sup>97</sup> (including pension plan contributions) to the members of the firm. If all the profits are withdrawn in the form of salaries, then there are no accumulated earnings,<sup>98</sup> no corporate tax, and no personal holding company income,<sup>99</sup> so that the net result is generally the same as that which exists in a partnership with each member's salary being in effect the same as his would-be share of partnership income. Therefore, the primary question becomes: what is a "reasonable salary"? In most law firms the amounts paid to each member will bear a reasonable relationship to services rendered. But in iso-

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<sup>96</sup> E.g., see Jones, "The Professional Corporation," 27 *Fordham L. Rev.* 353 (1958); Kahn, "The Wisconsin Service Corporation Law of 1961," 1962 *Wis. L. Rev.* 65; Maier & Wild, "Taxation of Professional Firms as Corporations," 44 *Marq. L. Rev.* 127 (1960); Notes, 46 *Iowa L. Rev.* 844 (1961), 12 *Stan. L. Rev.* 746 (1960).

<sup>97</sup> IRC § 162(a)(1).

<sup>98</sup> IRC §§ 531-37.

<sup>99</sup> IRC §§ 541-47.

lated cases, such as where a large salary is paid to an older or inactive member (who more often than not is the one who generates the business) who renders little direct service to the firm, the professional association or corporation might conceivably lose the salary deduction as being unreasonable in amount. This problem may also arise in certain family law firms where the father, for example, takes a salary disproportionate to that of his young lawyer son. Where the family law firm is run in the form of a partnership, the Code provides for an allocation of the partnership income first to the father for his reasonable compensation for services rendered, with the remainder divided according to each partner's distributive share.<sup>100</sup> This same principle is carried over to family corporations electing Subchapter S treatment.<sup>101</sup> In the case of the family partnership or family Subchapter S Corporation the reasonable salary problem is not as serious as it is in the case of the regular corporation where the double-tax would result upon disallowance of any part of a salary deduction considered unreasonable in amount. Therefore, for example, if a father and his two sons (all lawyers) were to form an association and it was determined by the Internal Revenue Service that the salary paid to the two sons was too high (i.e., unreasonable in amount), unless the association elected to be taxed as a Subchapter S Corporation the unreasonable amount of salary could not be re-allocated to the father to avoid both the corporate tax and the tax to the sons on that amount.<sup>102</sup>

Those professional associations or corporations who cannot draw out all of the profits in the form of salary or other deductible expenses may minimize the double-tax burden to some extent by purchasing insurance on the lives of their members. Although life insurance premiums are not deductible<sup>103</sup> in computing the association or corporation taxable income, the excess of the premiums paid over any cash surrender value will reduce the earnings and profits account (i.e., the amount available for the second tax as dividends); and if care is taken not to give the member-insured any irrevocable rights in the policy, the premium payments will not be taxed as a dividend to the member.<sup>104</sup>

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<sup>100</sup> IRC § 704(e)(2).

<sup>101</sup> IRC § 1375(c).

<sup>102</sup> Further implications of this problem involve the question of whether or not the amount taxed to the sons represents dividend or salary. If a dividend, is it eligible for the \$50.00 exclusion and 4% credit? How is this amount treated for pension plan purposes?

<sup>103</sup> IRC § 264(a).

<sup>104</sup> E.g., *Sanders v. Fox*, 253 F.2d 855 (10th Cir. 1958); *Prunier v. Commissioner*, 248 F.2d 818 (1st Cir. 1957); *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957); *Rev. Rul. 184, 1959-1 Cum. Bull. 65*. Related to these problems are estate tax consequences on incidents of ownership of life insurance policies (IRC § 2042), and transfers of policies to a corporation in which the insured is a shareholder as compared to transfers to fellow stockholders (IRC § 101(a)(2)).

If the professional association or corporation still has a taxable income after deducting salaries, expenses, and insurance premiums, another way to overcome the double-tax burden is the Subchapter S election. It is somewhat paradoxical that the declared Congressional purpose in allowing certain "small business corporations" to avoid the corporate tax on the condition that the shareholders report their pro rata share of the corporate income (whether distributed or not) on their own returns, was to allow certain taxpayer groups to choose their legal entity without tax influences.<sup>105</sup> Another example of this same Congressional purpose is Subchapter R of the Code which permits certain individuals and partnerships to elect irrevocably to be taxed as a corporation.<sup>106</sup> Lawyers and other professional folk are precluded from utilizing this Subchapter R election because of its express limitation to enterprises where capital is a material income-producing factor.<sup>107</sup> Furthermore, although Subchapter R permits general corporate tax treatment, it specifically denies corporate pension and profit-sharing benefits to the owners of such unincorporated businesses.<sup>108</sup> Although it is difficult to understand who would desire the Subchapter R election, it is reported that, "Rumor has it that a cotton brokerage partnership prevented by state law from incorporating was the intended beneficiary."<sup>109</sup>

Although those who derive their income from personal service are precluded from Subchapter R, they are permitted to be a Subchapter S Corporation, provided all of the requirements are met. To be eligible for Subchapter S treatment a corporation cannot derive more than 20% of its gross receipts from royalties, rents, dividends, interest, annuities, and sale or exchanges of stock or securities.<sup>110</sup> Since personal service income is not included professional associations or corporations with ten or fewer associates or stockholders are presumably eligible for the election. Despite the declared Congressional purpose in enacting this election to enable non-tax considerations to govern the choice of entity, most professionals who elect the corporate form will be doing so for the tax advantages of qualified pension plans. In this connection it should be noted that the Treasury Department has in the past proposed legislation to prohibit Subchapter S Corporations from obtaining corporate pension plan benefits.<sup>111</sup> The passage of HR-10 might give new incentive to

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<sup>105</sup> S. Rep. No. 1622, 83d Cong., 2d Sess. 119 (1956).

<sup>106</sup> IRC § 1361.

<sup>107</sup> IRC § 1361(b)(4).

<sup>108</sup> IRC § 1361(d).

<sup>109</sup> Surrey & Warren, *Federal Income Taxation* 1470 (1960).

<sup>110</sup> IRC § 1372(e)(5).

<sup>111</sup> E.g., H. R. 9003, 86th Cong., 1st Sess., 104 Cong. Rec. 17,638 (1959).

Treasury efforts to block professional self-employed persons (and other small business groups) from the more liberal corporate pension plan provisions.

The Subchapter S Corporation undoubtedly has its advantages for some taxpayer groups. For example, those corporations that anticipate operating losses will be guaranteed the deduction of these losses against the stockholders' other income by electing Subchapter S treatment.<sup>112</sup> However, lawyers and other professionals (especially those interested in corporate fringe benefits) hardly ever have operating losses. In addition, lawyers should not make the erroneous assumption that a Subchapter S Corporation is taxed as if it were a "partnership." There are many significant differences between a Subchapter S Corporation and a partnership.<sup>113</sup> Death or withdrawal of an associate or shareholder not only immediately terminates the Subchapter S election for the entire firm, but any undistributed and previously taxed earnings cannot be distributed tax-free to the retired associate or to a deceased associate's estate.<sup>114</sup> A Subchapter S Corporation must have unanimous consent of the associates or shareholders<sup>115</sup> (thus making it cumbersome for the expanding law firm), and even though an estate of a deceased member can consent to the continuance of the Subchapter S election, in the case of lawyers, for example, the Canons of Ethics and state statutes themselves normally prohibit a non-lawyer from having a proprietary interest in a law practice. What effect would this have on the Subchapter S election? Since Section 1371 requires "one class of *stock*" (emphasis added), will professional associations or corporations which do not issue actual shares of stock be ineligible for the Subchapter S election? This observation may be criticized as an unduly technical and literal reading of the statute, but here again lawyers may find the Treasury using all the ammunition it has (no matter how illogical) to stop the run on pension plan benefits.

The law firms with more than 10 "owners" are the ones most likely to have "unreasonable salary" and double-tax problems. However, even though Subchapter S is not available to these firms, the personal holding company 75-85% penalty tax will also be avoided where more than 5 members own over 50% of the interest in the firm.<sup>116</sup>

Once the embattled lawyer works his way through the specific complex statutory requirements pertaining to the formation and operation of a

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<sup>112</sup> IRC § 1374.

<sup>113</sup> See Caplin, "Subchapter S vs. Partnership: A Proposed Legislative Program," 46 Va. L. Rev. 61 (1960).

<sup>114</sup> IRC §§ 1372(e), 1375(d).

<sup>115</sup> IRC § 1372(a).

<sup>116</sup> IRC §§ 541, 542(a)(2). For other exceptions to the personal holding company tax see IRC § 542(c).

corporation and is just about to make the decision to form a corporation or association, he is faced with Section 269. That section provides, among other things, that if "any person or persons acquire or acquired . . . control of a corporation . . . and the *principal purpose* for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person . . . would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed." The apparent purpose for the enactment of this section was to prevent avoidance of the excess-profits tax and to stop purchases of loss corporations purely for tax reasons. If Section 269 were taken literally, however, it could apply to all cases where tax considerations were the principal factors in selecting the corporate form of doing business. The fact that there have been very few government victories in this area indicates the difficulty of proving a principal tax avoidance purpose. Although most lawyers who form associations or corporations are readily apt to admit that the corporation retirement plan was the principal purpose for their action, it is conceivable that many professional persons, especially solo practitioners, may find the association a more efficient and natural way to conduct a professional practice aside from tax considerations. The traditional business corporation, however, always has the convenient concept of limited liability as a dominant purpose in forming a corporation. The professional corporation and association statutes of the various states, together with the peculiarities of the legal profession (and other professions), in effect prohibit the limited liability concept from being advanced by professional persons as their principal purpose in forming a corporation or association. Although in the long run Section 269 will probably be one of the minor hurdles (or no hurdle at all) for the professional to overcome, at the present time it is another weapon in the hands of the Internal Revenue Service as a means of discouraging the professional association or corporation. If the government wants to preclude the professional person from corporate pension and profit-sharing plan benefits, it should do so by direct legislation to that effect.

The operation of a law practice in corporate form might mean the loss of certain tax benefits available exclusively to non-corporate taxpayers. For example, Section 1301 is a special averaging device which provides that where 80% or more of the compensation or fees pertaining to one particular project or case are collected in one taxable year the amount received may be spread back ratably over the period that the services were rendered, provided such period exceeds thirty-six months. This section was apparently passed for members of the legal profession who

have, for example, many contingent fee cases and the like which with docket delays, etc., may extend beyond three years. Since the benefits of this section are expressly available only to individuals or partnerships, the professional corporation or association will lose this averaging device even if the Subchapter S election were in force.

Any intelligent comparison of the partnership and corporate tax provisions and their effect on the professional person should include the tax consequences of one partner or associate doing business with a partnership or association. Will he be deemed to be transacting business with himself, with an aggregate of individuals including himself, or with a completely separate entity?<sup>117</sup> Will the corporate treatment of capital gains and losses differ materially from that of the partnership structure? Some of the fringe benefits such as the sick-pay exclusion,<sup>118</sup> group life insurance (often limited to organizations with 10 or more employees), medical and health benefits,<sup>119</sup> split-dollar insurance, deferred compensation plans,<sup>120</sup> and the \$5000 death benefit,<sup>121</sup> etc., which are now available to corporate taxpayers may provide more actual tax saving than the pension and profit-sharing plan. Before the professional puts too much emphasis on any one or more of these fringe benefits he should remember that the current Tax Reform Bill proposes to repeal such things as the sick-pay exclusion and certain group medical benefits. There is also a strong possibility for the enactment of new averaging devices for those who render personal services. Such provisions may not be applicable to income earned by or through an association or corporation. Furthermore, any changes in the corporate and individual rate structure will undoubtedly have an effect on whether or not to incorporate, especially with regard to those firms that will not be able to distribute all of their current income and thereby become subject to both the corporate and individual tax. Finally, it is to be observed that some states have taxes on corporate profits but not on non-corporate profits. How will associations be treated for state tax purposes?

#### *E. Some Comments on the Termination of the Professional Association or Corporation*

If the government allows professionals to enter the indefinable corporate tax cage, will these professionals later look out with envy at their less

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<sup>117</sup> IRC § 707.

<sup>118</sup> IRC § 105(d).

<sup>119</sup> IRC §§ 105, 106.

<sup>120</sup> However, the deferred compensation arrangement may be unattractive for a law firm where the future solvency and stability of the firm may be uncertain.

<sup>121</sup> IRC § 101(b).

greedy (perhaps more conservative is a better term) kinfolk who remained in the partnership tax arena? The transition from a partnership to a corporation is not a taxable event assuming compliance with Section 351. However, if the corporate environment proves to be disagreeable, a change back to partnership form will in most cases be an expensive proposition. A complete liquidation of a corporation is generally a taxable event even though the stockholders plan to continue the business in partnership form. In the case of law firms that are taxed as corporations, the items that will cause the most concern on liquidation are the previously untaxed accounts receivable (perhaps defined to include the value of retainers and work in process) and possible good will. The other assets, such as the law library, office equipment, and other property which have values higher than the adjusted bases will also produce taxable gain.

Unlike the partnership, the corporation is a separate taxable entity, and therefore the complete liquidation of the law association or corporation could produce double-tax problems. Those law corporations that liquidate within a short time after their formation also run the risk of being classified as "collapsible corporations."<sup>122</sup> Although a Subchapter S election solely for liquidation purposes might remove the double-tax burden, the lack of coordination between the collapsible corporation provision and the use of Subchapter S makes this a very dangerous area around which to plan.

When the corporation distributes the unrealized receivables to its members in return for all of their stock or all of their interests in the corporation, is there a tax to the corporation? Section 336 states that "no gain or loss shall be recognized to a corporation on the distribution of *property* in partial or complete liquidation" (emphasis added).<sup>123</sup> But here again what is meant by "property"? Does it include receivables? A Second Circuit case<sup>124</sup> and Court of Claims case<sup>125</sup> say "no," while the Sixth and Ninth Circuits<sup>126</sup> say "yes." The theory used for taxing the corporation is that it is an anticipatory assignment of income to its shareholders. However, some cases which have applied the assignment of income doctrine seem to limit it to the income that has been "earned" as distinguished from future rights to income where the actual services have not yet been rendered.<sup>127</sup> Applying this reasoning to the law firm, it is possible that

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<sup>122</sup> IRC § 341.

<sup>123</sup> The only express exception to this rule relates to the disposition of installment obligations. IRC § 453(d).

<sup>124</sup> *J. Ungar, Inc. v. Commissioner*, 244 F.2d 90 (2d Cir. 1957).

<sup>125</sup> *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961).

<sup>126</sup> *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957), *United States v. Horschel*, 205 F.2d 646 (9th Cir. 1953).

<sup>127</sup> E.g., see *Williamson v. United States*, *supra* note 125. Cf. *J. Ungar, Inc. v. Commissioner*, *supra* note 124.

only that portion of the receivables attributable to services already rendered would be taxed as ordinary income to the corporation. The remainder (work in process and value of the retainer contracts) would be taxed to the distributees when the services were rendered and the fees collected. That portion of the receivables that is taxed to the corporation would of course become part of the corporation's ordinary income for the final taxable year; and if all of the corporate profits in the final year could be withdrawn in the form of reasonable salaries and other deductible expenses, there would be no double-tax problems. On the other hand, where the corporate profit cannot be completely wiped out by salary and expense deductions the excess will be deemed to be capital gain to the distributee shareholders or associates unless the collapsible corporation provision converts to ordinary income that portion of the receivables which was not taxed to the corporation.<sup>128</sup> In most instances, however, the exceptions to the collapsible corporation rules will apply to law firms. In the final analysis it might be possible for at least a portion of the accounts receivable to be taxed only once at capital gain rates to the individual shareholders or associates, and the basis for these receivables in the hands of the partnership will be their fair market value at the time of liquidation of the corporation or association.

The next item that will cause problems on the termination of a law association or corporation is good will. It is certainly questionable whether good will should be a factor in a personal service organization, especially small or medium-size law firms where reputation and future income are so closely connected with the individual members of the firm. In fact, the Internal Revenue Service has itself questioned the existence of good will where, for example, an accountant sold his accounting business and sought to allocate a portion of the price to good will, a capital asset.<sup>129</sup> But the Tax Court has held that where a going professional practice is sold, part of the price is for good will.<sup>130</sup> Where a corporation distributes all of its assets in a complete liquidation, now that the shoe is on the other foot, the Internal Revenue Service will most likely argue that even though no money is being paid for good will, the distributees ought to be considered as having received all of the corporation's good will even though a good part of it was built up prior to the incorporation.

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<sup>128</sup> IRC §§ 331, 341.

<sup>129</sup> *Wylar v. Commissioner*, 14 T.C. 1251 (1950); *Horton v. Commissioner*, 13 T.C. 143 (1949). Also see *Cullen v. Commissioner*, 14 T.C. 368 (1950). Rev. Rul. 480, 1957-2 Cum. Bull. 49 states that an interest in good will in a professional partnership can be sold only when an interest in the firm name is sold, and the seller agrees to the continued use of his name in the partnership. See *Tenen*, supra note 92, at 154. See also notes 273-84 infra and accompanying text.

<sup>130</sup> See cases cited note 129 supra.



Where the professional persons do not continue the practice of law in partnership or individual form after the corporate liquidation, there should be no tax on good will. Where the distributees are taxed on an amount (which will be difficult to ascertain) as good will, they should of course be allowed to add this to their basis for their partnership interests.

If the professional association or corporation proves to be a fruitful experience, there are further problems to consider on the death, retirement or withdrawal of a member of such an organization, as compared with the tax implications involved when the partnership form is used. A withdrawing or retiring member of a law firm can terminate his interest by various means. He can have the partnership or corporation pay him for his interest; he can sell his interest to the remaining partners or stockholders; or he can sell his interest to an outsider (provided that the partnership or corporation agreements allow). In the case of a partnership there are further problems such as premature closing of the partnership and partners' tax years, and bunching of income. A transfer of a partnership interest either by sale to a partner or to an outsider, or by redemption by the partnership itself will generally produce ordinary income to the withdrawing or retiring partner on his share of the partnership income as of the effective date of the termination of his interest.<sup>131</sup> In each of these cases the partnership year closes with respect to the selling partner;<sup>132</sup> and where there has been a sale (by withdrawing, retirement, or direct sale) of at least a 50% interest in the profits and capital of the partnership, the partnership year will close with respect to all the partners.<sup>133</sup> In addition to his share of partnership income up to the date of termination of his interest the selling partner will be taxed at ordinary income rates on that portion of the selling price which equals the value of his interest in the unrealized receivables (broadly defined).<sup>134</sup> The balance of his gain, if any, will be taxed at capital gain rates.<sup>135</sup> Where the retiring partner in effect sells his interest to the partnership itself the rules may vary somewhat, depending upon the partnership agreement. As we have previously indicated, the incidents of taxation can be shifted among the partners by means of an express provision in the agreement regarding the payment of good will.<sup>136</sup> Therefore some of the ordinary income can be converted into capital gain to the

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<sup>131</sup> See Jackson, Johnson, Surrey, Tenen & Warren, *supra* note 87.

<sup>132</sup> IRC § 706(c)(2).

<sup>133</sup> IRC §§ 706(c), 708(b)(1)(B).

<sup>134</sup> IRC § 751.

<sup>135</sup> IRC § 741.

<sup>136</sup> IRC § 736(b); notes 90-92 *supra* and accompanying text; see also notes 273, 278, 281, 285 *infra*.

selling partner, but the remaining partners will be taxed on a higher share of the partnership income.

The tax consequences on the withdrawal or retirement of an associate or stockholder from a professional association or corporation will be quite different from the results which obtain in the partnership. In the first place, the taxable years of the association or corporation and the associates or stockholders will not close on termination of the member's interest in the firm. As with the partnership, there are various ways for a member to "sell out." Subject to the terms of any buy-out agreements, the retiring member can sell his stock or beneficial interest to an outsider, to a member or members of the firm, or to the firm itself by way of a redemption. Unlike the partnership situation, however, the sale or redemption will normally be a capital asset transaction.<sup>137</sup> In most cases the selling member's share of unrealized receivables will therefore be taxed at capital gain rather than at ordinary income rates. The regular problems applicable to all corporate stock redemptions, such as the possibility of constructive dividends to the continuing shareholders, the stock attribution rules<sup>138</sup> (particularly acute in family organizations) will have their place in the professional association or corporation, but proper tax planning can go a long way in eliminating most of these problems.

The death of a partner does not ordinarily close the taxable year of the partner or partnership. The tax consequences are in most respects the same as those with regard to the withdrawal or retirement of a partner. The most significant problems that arise on the death of a partner are with regard to the estate tax, the income tax basis provision,<sup>139</sup> and the provision relating to "income in respect of a decedent."<sup>140</sup> Here again the partnership agreement will largely govern the tax results. The value of the partnership interest of the deceased partner will be includible in his gross estate for Federal Estate Tax purposes.<sup>141</sup> Included in this interest will be the deceased partner's share of unrealized receivables and his portion of undistributed partnership income up until the date of death. For Federal Income Tax purposes, however, all of the decedent's share of the partnership income for his final year is not reported on his final income tax return, but instead it is reportable by the estate or the beneficiaries of the estate as "income in respect of a decedent." In addition, any payment to the estate for the decedent's interest in unrealized

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<sup>137</sup> But see discussion at note 82 *supra* and accompanying text.

<sup>138</sup> IRC § 302.

<sup>139</sup> IRC § 1014(c).

<sup>140</sup> IRC § 691.

<sup>141</sup> IRC § 691(c) permits deduction for estate taxes on that portion of the estate tax attributable to income in respect of a decedent.

receivables and good will (in the absence of a specific provision in the agreement calling for the payment of good will) will be taxed in full as ordinary income in the hands of the estate or beneficiaries of the estate as income in respect of a decedent.<sup>142</sup> In other words, for basis purposes the only items that will receive a stepped-up basis in the hands of the estate will be capital and not income items.

The most significant difference, therefore, between the corporation and partnership form on the death of a member of a law firm is in the classification of assets such as unrealized receivables and good will. In the case of a corporation if the entire beneficial interest of the decedent is deemed to be a capital asset, then the decedent's share of the unrealized receivables and good will (if any) will not be income in respect of a decedent, and thus in the usual case not taxed at all to the decedent's estate because of a stepped-up basis of the property in the hands of the estate.<sup>143</sup> In the case of a corporation, even if the amount allocable to good will is not spelled out in any agreement, it is treated as a capital item and not as an income item. Although the partnership provisions have a great deal of flexibility it seems that as long as sales and redemptions of corporate interests steer clear of the constructive dividend provisions of Section 302, the incidents of taxation can be more beneficial to the estate of a deceased member of a corporation than they are to an estate of a deceased member of a partnership.

Before the professional person can make any decision as to whether or not to form an entity which will be taxed as a corporation he must have more definite assurance that the Internal Revenue Service will not classify this as a tax-avoidance scheme. Other problems that need to be fully explored in each individual case are the need for the issuance of shares of stock and the tax treatment of the transfer of accounts receivable—whether this item will be deemed "property" or "income." Above all, each professional group before it can chart its course must map out all of the relative tax gains as against all of the costs of being taxed as a corporation. The pension and profit-sharing plans should be qualified by the Internal Revenue Service before any change in entity is actually made. Lawyers should be aware that each type of law firm has its own quagmire of problems.

Assuming that the rewards of practice in corporate form make it worthwhile to encounter the tax problems involved, further questions still

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<sup>142</sup> IRC §§ 736(a), 753, 1014(c). But see notes 273-84 *infra* and accompanying text regarding the ethical restrictions on the transfer of good will by an attorney.

<sup>143</sup> IRC § 1014. In this connection it should be observed that the 1963 "Tax Bill" recommends a capital gains tax on transfers of appreciated property (i.e., basis lower than value) at death.

remain. Can such practice be sanctioned under the standards of ethics of the particular profession? Will the adoption of an ethically acceptable corporation or association satisfy the Kintner regulations and permit the organization to be taxed as a corporation?

## II

### THE KINTNER REGULATIONS AND THE NEW LOCAL LAWS

On November 15, 1960, the Treasury Department adopted new regulations defining "association" for the purpose of the federal income tax laws.<sup>144</sup> An organization's classification, according to the regulations, depends solely on a corporate resemblance test: If it has more corporate characteristics than non-corporate characteristics, it will be determined to be an association and thus taxed as a corporation. The regulations declare that the major characteristics of a corporation are (1) associates, (2) an objective to carry on a business and divide the profits therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate assets, and (6) free transferability of interests. The first two characteristics are considered essential, but since they are common to both corporations and partnerships, an organization to be classed as a corporation rather than a partnership must have more of the other four corporate attributes than it lacks. In addition, other less significant characteristics of a corporation or non-corporate entity may be given some weight in the determination.

These regulations were passed in response to *United States v. Kintner*,<sup>145</sup> and have become known as the Kintner regulations, but it is dangerous to assume that these regulations constitute administrative recognition of the principles of that case. As in *Kintner*, an organization's

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<sup>144</sup> Treas. Reg. § 301.7701-2 (1960). The case and Treasury Department history leading up to the new regulations has been adequately covered elsewhere. See e.g., articles cited at note 96 supra. The leading case on the subject is *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The essence of this case is that to be an "association," an organization must have (1) associates engaged in a joint business enterprise, and (2) characteristics which make it resemble a corporation. Such characteristics are: (a) legal title to the property of the enterprise in a corporate-like entity; (b) centralized management; (c) continuity of life; (d) limited liability; (e) free transferability of interests. The *Morrissey* case involved a trust which had at one time 920 beneficiaries and only two trustees, thus resembling the traditional separation of ownership and management in a large business corporation. Subsequent to *Morrissey*, the government successfully argued that several Illinois doctors who entered into a trust arrangement were taxable as an "association." *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936). Then in 1954, a doctor-taxpayer was able to convince the courts, over the government's strong objections, that an unincorporated association of doctors should be classed as an "association" and thus taxed as a corporation. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), aff'g, 107 F. Supp. 976 (D. Mont. 1952). A similar conclusion was reached independently of the Kintner case, but in agreement with it, in *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959). See also notes 306-09 infra and accompanying text.

<sup>145</sup> 216 F.2d 418 (9th Cir. 1954). See notes 11, 144 supra.

classification is made to depend on a corporate resemblance test; but the regulations differ from *Kintner* in the weight assigned to the various corporate characteristics.<sup>146</sup> Federal tax law is said to control, as it did in the *Kintner* case, the classification of an organization for tax purposes; but the regulations also differ from *Kintner* by looking to state law to determine whether or not the required corporate characteristics are in fact possessed—and can be legally possessed—by the organization.<sup>147</sup> Thus, even though the articles of association provide that the association shall continue to exist notwithstanding the death of a member, if, under the applicable state law, such death would nevertheless cause the technical dissolution of the organization, the characteristic of continuity of life would not be possessed by the organization.

Several states have responded to the new regulations by authorizing professionals to form corporations or associations which will possess some or all of the major corporate characteristics specified by the regulations.<sup>148</sup> Four of these states have limited the corporate authorization to physicians (and in one case physicians and dentists).<sup>149</sup> Perhaps these medical corporation statutes reflect an awareness of a stricter policy against the corporate practice of law and other professions than against the practice of medicine in corporate form. More likely, they are evidence of the active and effective medical lobbying in the various states. In any event, the states of Arizona, Florida, Kentucky, Michigan, New Jersey, Oklahoma and Wisconsin have authorized lawyers as well as doctors and other professionals to form corporations for the practice of their respective professions,<sup>150</sup> and the Colorado Supreme Court has

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<sup>146</sup> See notes 144 *supra*, 308-09 *infra* and accompanying text.

<sup>147</sup> Treas. Reg. § 301.7701-1(c) (1960); see notes 306-07 *infra* and accompanying text.

<sup>148</sup> See notes 149-54 *infra*. Comment, 16 Sw. L.J. 462, 470-79 (1962) contains a helpful chart and discussion of the extent to which the state statutes have met the regulations. Prior to the enactment of the new statutes, professionals, with but a few exceptions, were generally prohibited from practicing their professions in corporate form. See 1 Fletcher, *Cyclopedia Private Corporations* § 97 (1931); Maier & Wild, "Taxation of Professional Firms as Corporations," 44 Marq. L. Rev. 127 (1960); Note, 46 Iowa L. Rev. 844 (1961); note 149 *infra*. The prohibitions against a corporation practicing law are discussed in notes 158-208 *infra* and accompanying text.

<sup>149</sup> Ark. Stat. Ann. §§ 64-1701 to -1717 (physicians), 64-1801 to -1817 (dentists) (Supp. 1961); Conn. Gen. Stat. Ann. § 33-180 (1958) (medical clinics; adopted prior to the *Kintner* regulations); (Connecticut also has an association statute covering all professions, see note 154 *infra*); Minn. Stat. Ann. §§ 319.01-23 (Supp. 1962) (worded as if it applies to all professions but § 319.02(2) limits its coverage to physicians); S.D. Code 1961, ch. 29 (physicians). Missouri may also allow incorporation by doctors. *Sager v. Lewin*, 128 Mo. App. 149, 106 S.W. 581 (1907) (corporation supplied medical treatment through a qualified physician); Op. Att'y Gen. No. 8 (March 15, 1962); see also *State Electro-Medical Institute v. State*, 74 Neb. 40, 103 N.W. 1078 (1905); *State Electro-Medical Institute v. Platner*, 74 Neb. 23, 103 N.W. 1079 (1905) (out of state corporation employed doctors for the practice of medicine in Nebraska); *Doumitt v. Diemer*, 144 Ore. 36, 23 P.2d 918 (1933) (corporation engaged in taking X-ray pictures and giving X-ray treatments); note 154 *infra*.

<sup>150</sup> Ariz. Rev. Stat. Ann. §§ 10-901 to -909 (Supp. 1962); Fla. Stat. Ann. §§ 621.01-14

adopted a court rule which permits incorporation by attorneys.<sup>151</sup> Ohio has provided for *incorporated* associations of professionals,<sup>152</sup> and Tennessee has created a professional association which "shall be deemed and treated at law as a corporation and not a partnership."<sup>153</sup> Lawyers and other professionals also have been authorized to practice in the "association" form by statutes in Alabama, Connecticut, Georgia, Illinois, Pennsylvania, South Carolina, Texas and Virginia.<sup>154</sup> In addition, proposals

(Supp. 1962); Ky. Rev. Stat. §§ 274.005-990 (1962); Mich. Stat. Ann. § 21.315 (1962), 7 CCH 1962 Stand. Fed. Tax Rep. ¶ 6420; N.J. Stat. Ann. §§ 14:19-1 to -17 (1963), 7 CCH 1963 Stand. Fed. Tax Rep. ¶ 6284; Okla. Stat. Ann. tit. 18, §§ 801-19 (Supp. 1962) (excludes dentists); Wis. Stat. Ann. § 180.99 (Supp. 1963). See Bittker, "Professional Associations and Federal Income Taxation: Some Questions and Comments," 17 Tax L. Rev. 1, 25-28 (1961); Buchmann & Bearden, "The Professional Service Corporation—A New Business Entity," 16 U. Miami L. Rev. 1 (1961); Kahn, "The Wisconsin Service Corporation Law of 1961," 1962 Wis. L. Rev. 65.

The Michigan and New Jersey acts are quite similar to the Florida one, and only the significant differences will be noted herein. The Oklahoma statute will be used as an example herein since the Oklahoma Supreme Court has approved its usage by lawyers without an amendment of the state's Canons of Ethics. See note 165 *infra*.

<sup>151</sup> Colo. R. Civ. P., Rule 265 (Supp. 1961), as reported in New Professional Corp. Laws, CCH 1962 Stand. Fed. Tax Rep. ¶ 521; Bye & Young, "Law Firm Incorporation in Colorado," 34 Rocky Mt. L. Rev. 427 (1962). The adoption of a court rule of this nature seems advisable in all states desiring to permit lawyers to practice in the form of associations or corporations, a legislative act in addition to the court rule is probably necessary in most states. See Note, 37 Notre Dame Law. 545, 551-53 (1962). Because of the uniqueness of the Colorado approach, its rule will be referred to as an example herein.

<sup>152</sup> Ohio Rev. Code Ann. §§ 1785.01-08 (Page 1962). The provisions of this act generally parallel those of the professional corporation acts and it will be referred to herein as a corporation act. Vesely, "The Ohio Professional Association Law," 13 W. Res. L. Rev. 195, 197 (1962); see also Dunkel, "Professional Corporations," 22 Ohio St. L.J. 703 (1961); Note, 31 U. Cinc. L. Rev. 71 (1962). But see 31 U. Cinc. L. Rev. 341, 343-44 (1962). Under a recent decision of the Ohio Supreme Court, lawyers will be unable to organize associations under this act unless the court changes its rules to admit corporations to the practice of law. Ohio ex rel. Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962), 48 Iowa L. Rev. 490 (1963); 14 Syracuse L. Rev. 104 (1962); 31 U. Cinc. L. Rev. 341 (1962). The Ohio attorney general has also ruled that an out of state corporation cannot practice engineering in Ohio since it was neither authorized to practice under the Ohio act nor under legislation in its own state. Op. Att'y Gen. 2495 (1961), as reported in New Professional Corporation Laws Explained, CCH 1962 Stand. Fed. Tax Rep. ¶ 584 (hereinafter cited as CCH Pamphlet).

<sup>153</sup> Tenn. Code Ann. § 61-105 (Supp. 1962) (amendment to the Uniform Partnership Act). The provisions of this statute generally are more similar to the association acts than the corporation acts, and it will be referred to herein as an association act. See Comment, 29 Tenn. L. Rev. 437 (1962). Since this statute does not expressly repeal inconsistent laws and Tenn. Code Ann. § 29-303 (1956) prohibits the practice of law by corporations or associations, the question has been raised as to whether attorneys may practice as associations under the new statute. Comment, 29 Tenn. L. Rev. 437, 446 (1962). See also note 154 *infra*.

<sup>154</sup> Ala. Laws 1961, act 865; Conn. Gen. Stat. Rev. § 34-82 (1962) (amendment to the Uniform Partnership Act adopted concurrently); Ga. Code Ann. §§ 84-4301 to -4318 (Supp. 1961); Ill. Ann. Stat. ch. 106½, §§ 101-09 (Smith-Hurd 1962); Pa. Stat. Ann. tit. 14, §§ 197-1 to -19 (Supp. 1962); S.C. Code §§ 56-1601 to -1617 (Supp. 1962), 7 CCH 1962 Stand. Fed. Tax Rep. ¶ 6354; Tex. Civ. Stat. Ann. art. 6132(b) § (6)(3) (1962) (amendment to the Uniform Partnership Act adopted concurrently); Va. Code Ann. §§ 54-873 to -893 (Supp. 1962); see also Pa. Stat. Ann. tit. 59, §§ 341-461 (1930) (an 1874 Partnership Association Act which provides for more corporate characteristics than the 1961 association act). The Attorney General has rendered an opinion that doctors may organize and practice medicine under the old act. See CCH Pamphlet ¶ 602. But because of its provision for limited liability and a corporate trade name its application for lawyers is doubtful. See discussion, *infra*. The Connecticut and Tennessee (see note 153 *supra*) acts do not endow their associations with the corporate characteristics but merely authorize

have been made in several other states for the adoption of professional incorporation or association laws, and a model act has been prepared for Massachusetts by the Harvard Student Legislative Research Bureau.<sup>155</sup>

The determination of whether or not a group of lawyers can qualify for tax treatment as a corporation will depend on whether the new statutes have authorized sufficient corporate characteristics within the definitions stated in the Kintner regulations,<sup>156</sup> and whether the traditional taboos

professionals to adopt them and be excluded from the Uniform Partnership Act. See Bittker, *supra* note 150, at 22; Comment, 16 Sw. L.J. 462, 481 (1962). However, if the opportunity is presented, the state courts, in view of the tax purpose of the legislation and to clarify the business associations law, will probably construe the corporate attributes as having been bestowed on associations organized under the acts.

See Alabama Bar Ass'n Special Comm. Rep., "A Study of the Practical Ethical Considerations as to the Alabama Professional Association Act," 14 Ala. L. Rev. 79 (1961); Bittker, *supra* note 150, at 6-25; Specter, "Pension and Profit Sharing Plans: Coverage and Operation for Closely Held Corporations and Professional Associations," 7 Vill. L. Rev. 335, 343 (1962); Waisel, "Attorneys' Federal Income Taxes," 66 Dick. L. Rev. 75 (1961); Comment, 12 Mercer L. Rev. 388 (1961); Notes, 14 Ala. L. Rev. 258 (1961); 36 Conn. B.J. 271 (1962).

The Alabama and Virginia acts will be referred to herein as examples of the association-type statutes since the latter is the most comprehensive of the acts and the Alabama act is almost identical to the Georgia and South Carolina acts (the material differences will be indicated).

<sup>155</sup> See Harvard Student Legislative Research Bureau, "Incorporation of Professional Groups: A Model Act," 47 Mass. L.Q. 405 (1962). At the time of this writing bills authorizing professional corporations or associations were pending in at least fifteen states, including New York. See 7 CCH 1963 Stand. Fed. Tax Rep. ¶ 8573; N.Y. Times, August 5, 1962, § 3, p. F9, col. 2. See also Committee on Incorporation of Professional Groups Interim Rep., 5 Boston B.J. No. 11 p. 3 (1961); Lyon, "Action in Indiana on Kintner-Type Organizations," 39 Taxes 266 (1961). (The proposed bill in Indiana was not adopted.) Although Texas has authorized professionals to form associations, note 154 *supra*, the statute did not expressly provide for any corporate characteristics. While such associations will not be subject to the Uniform Partnership Act, it has not been determined what the law is that does govern them. See Bromberg, "Texas Uniform Partnership Act—The Enacted Version," 15 Sw. L.J. 386, 387-89 (1961). Consequently, new legislation may be proposed concerning the establishment of professional associations or corporations. See "Legislative Program Studied by Tax Section," 25 Texas B.J. 137 (1962).

<sup>156</sup> It is debatable whether the Kintner regulations should apply to entities organized under professional corporation—as distinguished from association—statutes. Since the regulations define "association" as used in IRC § 7701(a)(3), it can be asserted that they do not apply to the question of whether or not entities come directly within the scope of "corporation" as used in that section. However the new regulations have been applied to a medical clinic organized under a Connecticut "non-stock corporation" act. Colony Medical Group, Special Ruling, 5 CCH 1962 Stand. Fed. Tax Rep. ¶ 4939.23 (1961). This approach appears to be inconsistent with the treatment of business corporations which generally are not challenged unless the corporate form is clearly being used as a subterfuge. See *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); 1 O'Neal, *Close Corporations* § 1.09, at 19 (1958). *Id.* at § 8.17. See also Buchmann & Bearden, "The Professional Service Corporation—A New Business Entity," 16 U. Miami L. Rev. 1, 2, 22-23 (1961); Bye & Young, "Law Firm Incorporation In Colorado," 34 Rocky Mt. L. Rev. 427, 438-39 (1962); Eber, "Professional Service Corporations," 100 Trusts & Estates 758 (1961); Kahn, "The Wisconsin Service Corporation Law of 1961," 1962 Wis. L. Rev. 65, 90; Maier, "Don't Confuse Kintner-type Associations with New Professional Corporations," 15 J. Taxation 248 (1961). The validity of the corporate designation is further supported by the provisions in all the professional corporation statutes making the entities subject to the state's business corporation act except where it may conflict with the professional corporation act. See note 220 *infra*. Notwithstanding these contentions, one should be prepared to demonstrate that the professional corporations do possess the requisite corporate characteristics since it is not unlikely that the IRS will attempt to apply the Kintner regulations to entities organized under both types of statutes. See Alexander, "Some Tax Problems of a Professional Association," 13 W. Res. L. Rev. 212, 224-25, 232-33 (1962); Bittker, *supra*

against the practice of law in corporate form can be overcome. Included in the general inquiry is the more pertinent question of whether ethical considerations will require that the articles of association or incorporation contain restrictions which in turn may prevent the organization from qualifying under the tax regulations.<sup>157</sup> We will first consider some general prohibitions and objections to the practice of law by a corporation and then will discuss each corporate characteristic in light of its explanation in the regulations, its attempted authorization by the states, and any ethical limitations on its adoption by a law firm.

### A. *The Practice of Law by Corporations and Associations*

1. *General Considerations.* It has been said that there is "no judicial dissent from the proposition that a corporation cannot lawfully engage in the practice of law."<sup>158</sup> Witness a recent decision of the highest court of Connecticut: "Artificial creations such as corporations and associations cannot meet these prerequisites [for the practice of law] and therefore cannot engage in the practice of law."<sup>159</sup> Similarly, a 1961 opinion of the ABA Committee on Unauthorized Practice notes the prevailing dogma that: "corporations, laymen, and lay agencies are prohibited from practicing law directly and from practicing law indirectly by hiring lawyers to practice for them."<sup>160</sup>

Consequently, in all of the states authorizing the new professional organizations, deviations from the regular business corporation acts have been provided in an attempt to avoid infringing upon the traditional ethi-

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note 150, at 26-27; Vesely, *supra* note 152, at 207-08; Note, 75 Harv. L. Rev. 776, 784-85 (1962).

<sup>157</sup> It may be supposed that an association of professionals would encounter fewer ethical problems than a professional corporation. However, in order to qualify for tax treatment as a corporation, an association must possess many of the characteristics of a corporation. Thus there remains little practical difference between the two entities except for the more distasteful emotional reaction stirred by the vision of a corporation practicing law. See *Ohio ex rel. Green v. Brown*, 173 Ohio St. 114, 180 N.E.2d 157 (1962). See also "The Day Law Firms Went Public," 5 N.J.S.B.J. 865 (1962) for an example of the "wedge" approach (wedge the door open a little bit and the flood will follow) carrying the concept of the incorporation of law firms to absurdity.

<sup>158</sup> 5 Am. Jur. Attorneys at Law § 25 (1936). See also Annot., 73 A.L.R. 1327 (1931), supplemented in 157 A.L.R. 282 (1945); 105 A.L.R. 1364 (1936); ABA Comm. on Professional Ethics, Opinions 122 (1934), 8 (1925); note 160 *infra*.

<sup>159</sup> *State Bar Ass'n v. Connecticut Bank & Trust Co.*, 145 Conn. 222, 234, 140 A.2d 863, 870, 69 A.L.R.2d 394, 402 (1958).

<sup>160</sup> "Informative Opinion A of 1961," 47 A.B.A.J. 1133 (1961). Accord, *State Bar Ass'n v. Connecticut Bank & Trust Co.*, *supra* note 159, at 234, 140 A.2d at 870-71, 69 A.L.R.2d at 402; *Matter of Otterness*, 181 Minn. 254, 257, 232 N.W. 318, 319, 73 A.L.R. 1319, 1322 (1930); *Matter of Co-operative Law Co.*, 198 N.Y. 479, 483, 92 N.E. 15, 16 (1910); *Bender v. Lewis*, 73 Ohio St. 101, 76 N.E. 564 (1905); *Hexter Title & Abstract Co. v. Grievance Comm.*, 142 Tex. 506, 515, 179 S.W.2d 946, 953-54, 157 A.L.R. 268, 279 (1944); *Nelson v. Smith*, 107 Utah 382, 394, 154 P.2d 634, 640-41, 157 A.L.R. 512, 519 (1944); *State ex rel. Lundin v. Merchants Protective Corp.*, 105 Wash. 12, 17, 177 Pac. 694, 696 (1919); ABA Comm. on Professional Ethics, Opinion 8 (1925). See also note 158 *supra*.



cal responsibilities of the professional practitioner. However, while a legislature can determine who may be permitted to incorporate, its has been established in many jurisdictions that the courts and not the legislatures have the last word on who is qualified to practice law.<sup>161</sup>

As of this writing, three state courts and the Committee on Professional Ethics of the American Bar Association have given qualified approval for lawyers to carry on their practice in the form of a professional association or corporation.<sup>162</sup> The Supreme Court of Colorado has adopted a rule of court permitting lawyers to practice as service corporations under the Colorado Corporation Code provided that the corporation is operated in accordance with the provisions of the rule.<sup>163</sup> The Florida supreme court has approved amendments to its Canons of Ethics and rules governing integration of the bar in order to permit Florida lawyers to organize under that state's professional corporation act,<sup>164</sup> and the Oklahoma Supreme Court has held that lawyers may practice in the form of an Oklahoma Professional Corporation without infringing the Canons of Ethics.<sup>165</sup>

<sup>161</sup> E.g., *Heiberger v. Clark*, 148 Conn. 177, 169 A.2d 652 (1961); *People ex rel. Chicago Bar Ass'n v. Goodman*, 366 Ill. 346, 8 N.E.2d 941, 111 A.L.R. 1 (1937); *Matter of Day*, 181 Ill. 73, 54 N.E. 646 (1899); *Opinion of the Justices*, 279 Mass. 607, 180 N.E. 725 (1932); *State ex rel. Ralston v. Turner*, 141 Neb. 556, 4 N.W.2d 302, 144 A.L.R. 138 (1942); *Matter of Beldsoe*, 186 Okla. 264, 97 P.2d 556 (1939); *Olmstead's case*, 292 Pa. 96, 140 Atl. 634 (1928); *Rhode Island Bar Ass'n v. Automobile Service Ass'n*, 55 R.I. 122, 179 Atl. 139, 100 A.L.R. 226 (1935); *Matter of Levy*, 23 Wash. 2d 607, 161 P.2d 651, 162 A.L.R. 805 (1945); *Matter of Cannon*, 206 Wis. 374, 240 N.W. 441 (1932); 5 Am. Jur. *Attorneys at Law* § 15 (1936). See Notes 48 *Iowa L. Rev.* 490, 493-99 (1963); 37 *Notre Dame Law.* 545, 550-53 (1962). Cf. *Vesely*, supra note 152, at 204-05.

Notes, 14 *Syracuse L. Rev.* 104, 105-06 (1962); 31 *U. Cinc. L. Rev.* 341, 342, 347 (1962); 31 *U. Cinc. L. Rev.* 71, 79-80 (1962). See also *Harvard Student Legislative Research Bureau*, supra note 155, at 419 providing that the professional corporation act shall not apply to attorneys except to the extent and under the terms and conditions determined by the state's highest court.

<sup>162</sup> See notes 163-67 *infra*. Despite state approval to practice in corporate form, a significant problem still remains for those lawyers who practice before federal administrative agencies. If an agency does not permit an association or corporation to enter an appearance before it, the individual members of such an organization will be faced with many problems. Can the income from agency practice be included as income of the organization? If not, it may not be worthwhile for many lawyers to be members of a professional association or corporation since without the income from his agency practice, the lawyer could not set aside a sufficient sum to provide a realistic retirement fund. Can the expenses of operating the association practice be segregated from those attributable to an attorney's agency practice? These and other accounting problems may be difficult to resolve, and may make it unfeasible for such an attorney to seek corporate status unless the agencies he usually practices before grant recognition to the new professional entities. Perhaps the best approach for the agencies to take is to follow the lead of the amendments to the Treasury Department rules of practice which admit any attorney (or C.P.A.) in good standing in a state, and removes its restrictions regarding practice by employees of corporations or other such organizations. 27 *Fed. Reg.* 9918 (Oct. 9, 1962), amending, 31 *C.F.R.* Part 10; see proposed amendment, 27 *Fed. Reg.* 3611 (Apr. 14, 1962).

<sup>163</sup> *Colo. R. Civ. P.*, Rule 265 (Supp. 1961). See *Bye & Young*, supra note 156. Employees of such corporations are also authorized to appear in the Federal District Court for Colorado and the Circuit Court of Appeals for the 10th Circuit. *Id.* at 453 n.159.

<sup>164</sup> *Matter of The Florida Bar*, 133 So. 2d 554 (Fla. 1961). See also note 167 *infra*.

<sup>165</sup> *Matter of The Oklahoma Professional Corporation Act*, 7 *CCH Stand. Fed. Tax Rep.* ¶ 8522 (1962). The court noted that the corporation would not engage in the practice of law, rather the corporate form would be used by individuals engaging in law practice.

The ABA opinion distinguishes a previous opinion which considered it improper for lawyers to practice in the form of a Massachusetts Trust,<sup>166</sup> and concludes that a professional corporation or association can avoid violating the Canons of Ethics if appropriate safeguards are observed.<sup>167</sup> The Ohio supreme court, however, has refused to issue a writ of mandamus requiring the Secretary of State to accept articles of incorporation of lawyers for filing under the Ohio incorporated association act.<sup>168</sup> The court did not reach the ethical questions but instead relied on its rules which limited admission to practice to natural persons. The validity of the reasoning underlying these recent actions, as well as the older decisions forbidding the corporate practice of law should greatly influence the approach to be taken in the remaining states.<sup>169</sup>

<sup>166</sup> ABA Comm. on Professional Ethics, Opinion 283 (1950).

<sup>167</sup> ABA Comm. on Professional Ethics, Opinion 303 (1961), 48 A.B.A.J. 159 (1962). See ABA Special Comm. to Cooperate with the ABA Comm. on Professional Ethics Re Ass'ns of Attorneys Taxable as Corporations Rep., ABA Section of Taxation Bull. 41 (Oct. 1961); American Bar Foundation Research Memo No. 28, "Ethical Problems Raised by the Association and Incorporation of Lawyers" (Greenwood, Research Attorney Nov., 1961) (contains a bibliography of articles on professional associations and the problems of ethics involved). See also Alabama Bar Ass'n Special Comm. Rep., "A Study of the Practical Ethical Considerations as to the Alabama Professional Association Act," 14 Ala. L. Rev. 79 (1961) which concludes that "thoughtful attention to ethical considerations should prevent their becoming an obstacle." *Id.* at 87. Further official action by the Alabama Bar Association was suspended pending the issuance of the ABA opinion. Note, 14 Ala. L. Rev. 258, 260 (1961). The Committee on Professional Ethics of the Connecticut State Bar Association has informally indicated its concurrence with the ABA opinion. "Report of the Committee on Professional Ethics," 36 Conn. B.J. 310, 311 (1962). The Philadelphia Bar Association has ruled that practice in the form of a professional association is not of itself a violation of the Canons of Ethics. See Spector, *supra* note 154, at 343 n.43.

The medical profession has endorsed practice in association or corporate form while the American Institute of Certified Public Accountants has opposed the use of the new statutes by C.P.A. However, some states have permitted their accountants to take advantage of their state's statute. See State Board of Accountancy v. Eber, 7 CCH 1963 Stand. Fed. Tax Rep. ¶ 9207 (Fla. Ct. App. 1963) (Notwithstanding a Board rule prohibiting the practice of accountancy in corporate form, the court held that accountants may incorporate under the Professional Service Corporation Act. The Board's rules cannot override legislative policy since the Board gets its rule-making powers from the legislature, and the professional relationship and standards are preserved by the Act.); Ky. Att'y Gen. Op. OAG 63-13, January 8, 1963, cited at 7 CCH Rep., *supra* at ¶ 9207 (Accountants can incorporate under the Kentucky statute); Buchmann & Bearden, *supra* note 156, at 12-13; Kahn, *supra* note 156, at 91; Notes, 75 Harv. L. Rev. 776, 789-90 n.79 (1962); 35 Temp. L.Q. 312, 316 n.29 (1962); 31 U. Cinc. L. Rev. 71, 84-85 (1962). The opposition of the accountants is based on avoiding anything which might make people think that accountants are limiting their liability or taking advantage of what some might consider to be a "tax gimmick," and for the practical reason that full time employees of a corporation were prohibited from practicing before the Tax Court. Editorial, 112 J. Accountancy 39 (Nov. 1961). Now that the latter reason is no longer valid (see note 162 *supra*) the accountants may reconsider their position.

<sup>168</sup> Ohio ex rel. Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962), 48 Iowa L. Rev. 490 (1963), 14 Syracuse L. Rev. 104 (1962), 31 U. Cinc. L. Rev. 341 (1962). The Ohio State Bar Association has petitioned the Ohio Supreme Court to consider changing its rules to permit practice by lawyers organized under the Ohio Act. But see the case notes cited, *supra*, suggesting that no rule change was necessary since it is the lawyers not the association which will be practicing.

<sup>169</sup> See Jones, "The Professional Corporation," 27 Fordham L. Rev. 353, 354-60, (1958); Lewis, "Corporate Capacity to Practice Law—A Study in Legal Hocus Pocus," 2 Md. L. Rev. 342 (1938); Ohl, "Corporate Practice of Law in New York," 40 Taxes 263 (1962);

2. *Requirements for Admission to Practice and Control over Conduct.* Lawyers, being vested with a public franchise and responsibility, must meet certain licensing requirements pertaining especially to character and education. Once admitted to practice, an attorney is subject to rules and standards for the breach of which he may suffer disbarment or other discipline. A corporation obviously cannot obtain a law degree or possess personal character traits,<sup>170</sup> but its owners and employees can.<sup>171</sup> Consequently, all of the professional association and corporation acts have provided that only qualified professionals may own interests in, and perform professional services for, the association or corporation.<sup>172</sup> Thus, the

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Wormser, "Corporations and the Practice of Law," 5 Fordham L. Rev. 207 (1936); Comment, 16 Sw. L.J. 462, 495-504 (1962); Note, 46 Iowa L. Rev. 844, 849-55 (1961), notes 158-160, 167 *supra*.

<sup>170</sup> See e.g., *People ex rel. Lawyers Institute v. Merchants Protective Corp.*, 189 Cal. 531, 209 Pac. 363 (1922); *State Bar Ass'n v. Connecticut Bank & Trust Co.*, 145 Conn. 222, 140 A.2d 863, 870 (1958); *Matter of Co-operative Law Co.*, 198 N.Y. 479, 92 N.E. 15 (1910); *State ex rel. Lundin v. Merchants Protective Corp.*, 105 Wash. 12, 17, 177 Pac. 694, 696 (1919).

<sup>171</sup> See Comment, 2 U. Chi. L. Rev. 119, 129 (1934) pointing out that corporations as such are also incapable of signing contracts or performing any other acts, but they can and do perform such acts through qualified individuals.

<sup>172</sup> E.g., Ala. Laws 1961, act 865, § 2: "Any two or more persons duly licensed to practice a profession under the laws of this State may form a professional association. . . ." Ala. Laws 1961, act 865, § 5:

A professional association may render professional services only through officers, employees, and agents who are themselves duly licensed or otherwise legally authorized to render professional service within this State. The term "employee" as used in this section does not include clerks, bookkeepers, technicians, nurses, or other individuals who are not usually or ordinarily considered by custom and practice to be rendering professional services for which a license or other legal authorization is required in connection with the profession practiced by a particular professional association, nor does the term "employee" include any other person who performs all his employment under the direct supervision and control of an officer, agent, or employee who is himself rendering professional service to the public on behalf of the professional association; provided, that no person shall under the guise of employment practice a profession unless duly licensed to practice that profession under the Laws of this State.

Ala. Laws 1961, act 865, § 9, set forth at note 267 *infra*. Colo. R. Civ. Proc., Rule 265 § I(B) (Supp. 1961): "The corporation shall be organized solely for the purpose of conducting the practice of law only through persons qualified to practice law in the State of Colorado." Colo. R. Civ. Proc., Rule 265 § I(D) (Supp. 1961), set forth at note 267 *infra*. Okla. Stat. Ann. tit. 18, § 804 (Supp. 1962): "One or more individuals each of whom is licensed to render a professional service may incorporate a professional corporation. . . . Such Articles of Incorporation shall . . . contain the following: . . . (c) a certificate by the regulating board of the profession involved that each of the incorporators, directors, and shareholders are duly licensed to practice such profession." Okla. Stat. Ann. tit. 18, § 811 (Supp. 1962):

A professional corporation may render professional services only through its officers, employees, and agents who are duly licensed to render such professional services; provided, however, this provision shall not be interpreted to include in the term "employee," as used herein, clerks, secretaries, bookkeepers, technicians, and other assistants who are not usually and ordinarily considered by custom and practice to be rendering professional services to the public for which the license is required.

Okla. Stat. Ann. title 18, § 809 (Supp. 1962), set forth at note 267 *infra*. Va. Code Ann. § 54-875 (Supp. 1962): "Any three or more individuals, each of whom holds a valid, unrevoked certificate or license to practice the same profession within this State, may organize a professional association for the purpose of rendering professional services of the kind its associates are authorized to render and dividing the gains therefrom . . ." Va. Code Ann. § 54-876 (Supp. 1962): "A professional association may render professional services only through officers, employees and agents, who are themselves duly licensed or otherwise legally authorized to render professional services within this State . . ." Va. Code Ann. § 54-885

licensing agency controls the activities of the organization through its authority over the individual practitioners, and, in some states, over the organization itself.<sup>173</sup> In addition, under a few of the statutes the franchise of an association or corporation may be suspended if the organization does not require prompt withdrawal of a disqualified member.<sup>174</sup>

(Supp. 1962): "The board of directors may engage whatever employees it deems necessary for the carrying on of the business of the association. No employee shall render professional services unless he is duly licensed or otherwise legally authorized to render such professional services within the State of Virginia." Va. Code Ann. § 54-888 (Supp. 1962), set forth at note 267 *infra*. Ariz. Rev. Stat. Ann. §§ 10-902.4, 10-907 (Supp. 1962); Conn. Gen. Stat. Ann. § 34-82 (1962); Fla. Stat. Ann. §§ 621.03(2), .07, .09 (Supp. 1962); Ga. Code Ann. §§ 84-4303, -4306, -4310 (Supp. 1961); Ill. Ann. Stat. ch. 106½, § 101 (Smith-Hurd 1962); Ky. Rev. Stat. §§ 274.045, -055 (1962); Mich. Stat. Ann. §§ 21.315(5), (8) (1962); N.J. Stat. Ann. §§ 14:19-7, -10 (1963); Ohio Rev. Code Ann. § 1785.02 -.03 (Anderson Supp. 1962); Pa. Stat. Ann. tit. 14, §§ 197-3, -8 (Supp. 1962); S.C. Code §§ 56-1603, 1606, 1610 (1962); Wis. Stat. Ann. §§ 186.99(2), (6) (Supp. 1963). Tennessee does not specify such requirements but they may be reasonably implied from the provisions that the association shall be subject to the laws regulating the practice of the profession and that shares can only be transferred to qualified nonmembers. Tenn. Code Ann. § 61-105(3)(d) (1955); see 29 Tenn. L. Rev. 437, 446 (1962).

<sup>173</sup> The following states retain the application over the members and professional employees of the laws and/or agency governing the particular profession. Ala. Laws 1961, act 865, § 6; Ariz. Rev. Stat. Ann. §§ 10-905, 909B (Supp. 1962); Colo. R. Civ. Proc., Rule 265 § II(C) (Supp. 1961); Fla. Stat. Ann. § 621.07 (Supp. 1962); Ga. Code Ann. § 84-4307 (Supp. 1961); Ill. Ann. Stat. ch. 106½, §§ 105, 106 (Smith-Hurd 1962); Ky. Rev. Stat. §§ 274.065, 075 (1962); Mich. Stat. Ann. § 21.315(6) (1962); N.J. Stat. Ann. § 14:19-8 (1963); Ohio Rev. Code Ann. § 1785.04 (Supp. 1962); Okla. Stat. Ann. tit. 18, §§ 812, 813 (Supp. 1962); Pa. Stat. Ann. tit. 14, § 197-4 (Supp. 1962); S.C. Code § 56-1603 (1962); Va. Code Ann. § 54-886 (Supp. 1962); Wis. Stat. Ann. §§ 186.99(8), (9) (Supp. 1963). The following states make the organization itself subject to the laws and/or agency governing the particular profession. Colo. R. Civ. Proc., Rule 265 § II(B) (Supp. 1961); Conn. Gen. Stat. Ann. § 34-82 (1962); Pa. Stat. Ann. tit. 14, § 197-4 (Supp. 1962); Tenn. Code Ann. § 61-105(3) (Supp. 1962); *Matter of The Florida Bar*, 133 So. 2d 554, 556 (Fla. 1961). Arizona, Colorado, and Oklahoma provide that their corporations may not do any act which an individual professional is prohibited from doing. Ariz. Rev. Stat. Ann. § 10-904A (Supp. 1962); Colo. R. Civ. Proc., Rule 265 § II(B) (Supp. 1961); Okla. Stat. Ann. tit. 18, § 814 (Supp. 1962), and in Colorado, if a corporation violates the rule of court permitting it to practice, it shall be grounds for the supreme court to terminate or suspend its right to practice law. Colo. R. Civ. Proc., Rule 265 § II(B) (Supp. 1961). See also *Bye & Young*, *supra* note 156, at 438; *Harvard Student Legislative Research Bureau*, *supra* note 155, at 418-19; *Comment*, 16 Sw. L.J. 462, 503-04 (1962). In addition to the inherent power of the courts to control the conduct of attorneys, and presumably lawyer-corporations, the courts also have power to curtail the unlawful practice of law by corporations, through *quo warranto*, injunction or contempt proceedings. *People ex rel. Los Angeles Bar Ass'n v. California Protective Corp.*, 76 Cal. App. 354, 244 Pac. 1089 (2d Dist. Ct. 1926) (*quo warranto*); *People ex rel. State Bar Ass'n v. People's Stock Yards Bank*, 344 Ill. 462, 176 N.E. 901 (1931) (contempt); *People ex rel. Courtney v. Ass'n of Real Estate Tax-payers*, 354 Ill. 102, 187 N.E. 823 (1933) (contempt); *Land Title Abstract & Trust Co. v. Dworken*, 129 Ohio St. 23, 193 N.E. 650 (1934) (*quo warranto*, injunction); *State Bar v. Retail Credit Ass'n*, 170 Okla. 246, 37 P.2d 954 (1934) (injunction); *State v. Retail Credit Merchant's Ass'n*, 163 Tenn. 450, 43 S.W.2d 918 (1931) (*quo warranto*, injunction); *Ilexter Title & Abstract Co. v. Grievance Comm.*, 142 Tex. 506, 179 S.W.2d 946, 157 A.L.R. 268 (1944) (injunction); See *Wormser* *supra* note 169, at 217-18. This power should not affect the attribute of continuity of life. See note 225 *infra*. Individuals aiding the authorized practice of law by corporations can, of course, also be disciplined. See *Matter of Otterness*, 181 Minn. 254, 232 N.W. 318, 73 A.L.R. 1319 (1930); *Matter of Pace*, 170 App. Div. 818, 156 N.Y. Supp. 641 (1st Dep't 1915); Canon 47; ABA Comm. on Professional Ethics, Opinion 122 (1934).

<sup>174</sup> E.g., Ala. Laws 1961, act 865, § 10; Fla. Stat. Ann. § 621.10 (Supp. 1962), N.J. Stat. Ann. §§ 14:19-11, -13c (1963); Wis. Stat. Ann. § 186.99(6) (Supp. 1963). Ariz. Rev. Stat. Ann. § 10-909(c) (Supp. 1962), Pa. Stat. Ann. tit. 14, § 197-18 (Supp. 1962), and Va. Code Ann. § 54-890 (Supp. 1962) require a disqualified employee or associate to forthwith disassociate himself from the organization. Ky. Rev. Stat. § 274.095 (1962) requires the

3. *The Corporate Entity as an Intermediary.* The relationship between a lawyer and his client is a personal one requiring the utmost confidence. It has been asserted that a corporation could not establish such a relationship, and that the entity would interfere with the confidential relation between its lawyer employees and their clients.<sup>175</sup> Canon 35 of the ABA Canons of Professional Ethics reads in part:

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 relation to his client should be personal, and the responsibility should be direct to the client.

The ABA Committee on Professional Ethics stated in its Opinion 283 that the practice of law in the form of a Massachusetts trust would violate Canon 35 because the "trust" would be an intermediary between lawyer and client. In the recent Opinion 303, however, the committee retreated from this mechanical approach and recognized that Canon 35 would not be violated merely because "there is legal entity distinct from the members of the organization . . ."<sup>176</sup> Indeed, a partnership has been recognized by many jurisdictions as a legal entity.<sup>177</sup> It is apparent that the principal evil which Canon 35 seeks to guard against is that of a *lay* agency or its

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redemption of the shares of a disqualified member within one year of his disqualification. The charter will become void if this is not done. It seems likely in the other states that if a lawyer, member or employee of a professional organization was disbarred or suspended, and he continued to participate in the activities or profits of the organization, such corporation or association would be in jeopardy of losing its franchise or being subject to other punitive measures. See also note 173 supra.

<sup>175</sup> *People ex rel. Lawyers' Institute v. Merchants' Protective Corp.*, supra note 170; *State Bar Ass'n v. Connecticut Bank & Trust Co.*, supra note 170; *People ex rel. Courtney v. Ass'n of Real Estate Tax-payers*, supra note 173; *Matter of Maclub*, 295 Mass. 45, 3 N.E.2d 272 (1936); *State ex rel. McKittrick v. C. S. Dudley & Co.*, 340 Mo. 852, 102 S.W.2d 895 (1937); *Matter of Co-operative Law Co.*, supra note 170; *People v. Peoples Trust Co.*, 180 App. Div. 494, 167 N.Y. Supp. 767 (2d Dep't 1917); *Land Title Abstract & Trust Co. v. Dworken*, supra note 173; ABA Comm. on Professional Ethics, Opinions 122 (1934), 10 (1926), 8 (1925). But see *Azzarello v. Legal Aid Society of Cleveland* (Ohio Ct. C.P., Jan. 4, 1962), 48 A.B.A.J. 382 (1962) holding that the legal aid society was not unlawfully practicing law and that it did not intervene in the attorney-client relationship nor control or advise the attorneys. See also Canon 35; ABA Comm. On Professional Ethics, Opinion No. 259 (1943); Comments, 3 U. Chi. L. Rev. 296 (1936), 2 U. Chi. L. Rev. 119, 126-29 (1934); note 193 infra.

<sup>176</sup> 48 A.B.A.J. 159, 161 (1962). It may be desirable to amend Canon 35 to provide that authorized professional associations or corporations shall not be deemed lay agencies or intermediaries. See note 179 infra.

<sup>177</sup> See *Caswell v. Maplewood Garage*, 84 N.H. 241, 246, 149 A. 746, 751-52, 73 A.L.R. 433, 439 (1930); *Crane, Partnership* § 3 (2d ed. 1952); *Stevens, Private Corporations* 32-36 (2d ed. 1949); Note, 41 Colum. L. Rev. 698 (1941); cf., ABA Comm. on Professional Ethics, Opinions 220 (1941), 181 (1938). It is interesting to note that working partners have been considered as employees of the partnership entity for purposes of workmen's compensation (*Scott v. Alsar Co.*, 336 Mich. 532, 58 N.W.2d 910 (1953); *Chisholm v. Chisholm Const. Co.*, 298 Mich. 25, 298 N.W. 390 (1941)) and unemployment compensation (*Finston v. Unemployment Compensation Comm'r*, 132 N.J.L. 276, 39 A.2d 697 (Sup. Ct. 1944), aff'd sub nom. *Naidech v. Unemployment Compensation Comm'r*, 134 N.J.L. 232, 46 A.2d 734 (Ct. Err. & App. 1946)). This is the status that members of a law firm want to achieve under the Internal Revenue Code.

stockholders exploiting or dominating the professional services of an attorney.<sup>178</sup> Such evil is not present with the associations and corporations created by the new statutes which all require that the members be licensed to practice the profession and that ownership may not be transferred to a non-professional.<sup>179</sup>

Among the reasons which have been said to justify the requirement of direct contact between attorney and client are the right of the client to select his own attorney,<sup>180</sup> and the need to have the lawyer base his advice on the particular facts of the client's case after the attorney has personally examined all the documents and asked all the questions which he deems relevant.<sup>181</sup> In the professional corporation or association these activities will continue to be carried on by the individual lawyer-employees directly with the clients.

Implied in the direct and personal responsibility to his client, is the duty of the attorney to avoid employment which involves a conflict of loyalties or interests.<sup>182</sup> It is thus feared that the attorney would owe some allegiance to his corporate employer which might conflict with that owed to his client.<sup>183</sup> Conflict of interest problems should be no more present in the

<sup>178</sup> See ABA Comm. on Unauthorized Practice, Informative Opinion A of 1962, 28 U.P. News 36 (#1, 1962); ABA Comm. on Professional Ethics, Opinion 303 (1961), 294 (1958), 98 (1933), 35 (1931), 32 (1931); Drinker, *Legal Ethics* 163-64 (1953); Vesely, *supra* note 152, at 206. See also *People ex rel. Los Angeles Bar Ass'n v. California Protective Corp.*, *supra* note 173, holding the practice of law by a corporation unlawful even if all directors and officers are attorneys since they may be succeeded by laymen through inheritance or transfer; *Matter of Co-operative Law Co.*, *supra* note 173, although the legal services were conducted by lawyers, laymen owned and controlled the corporation, and it was held to be unlawfully practicing law. Compare *Azzarello v. Legal Aid Society of Cleveland*, *supra* note 175.

<sup>179</sup> See notes 172 *supra*, 267 *infra*. Colo. R. Civ. Proc., Rule 265 § III (Supp. 1961) provides that its professional corporations "shall not be deemed lay agencies within the meaning of the Canons of Professional Ethics." The Florida opinion approved an amendment to Canon 35 declaring that its professional corporations "shall not be deemed lay agencies or such intermediaries." *Matter of The Florida Bar*, 133 So. 2d 554, 559 (Sup. Ct. 1961). N.J. Stat. Ann. § 14:19-7 (1963) provides: "Notwithstanding any other or contrary provisions of the laws of this State, a professional corporation organized under this act may charge for the services of its officers, employees, and agents, may collect such charges, and may compensate those who render such personal service." See also the discussion of centralized management, notes 231-44 *infra*.

<sup>180</sup> ABA Comm. on Professional Ethics, Opinions 266 (1945), 237 (1941), 10 (1926); Drinker, *supra* note 178, at 198-200. See also *State v. James Sanford Agency*, 167 Tenn. 339, 69 S.W.2d 895 (1934); ABA Comm. on Unauthorized Practice, Informative Opinion A of 1962, 28 U.P. News 36 (No. 2, 1962).

<sup>181</sup> ABA Comm. on Professional Ethics, Opinion 98 (1933); see also Opinion 270 (1945), 237 (1941), Informal Decision 508 (1962).

<sup>182</sup> See Drinker, *supra* note 178, at 103-07 (1953); Canon 6; ABA Comm. on Professional Ethics, Opinions 275 (1947), 103 (1933), 10 (1926). See also *State Bar Ass'n v. Connecticut Bank & Trust Co.*, 145 Conn. 222, 140 A.2d 863, 69 A.L.R.2d 394 (1958).

<sup>183</sup> *People ex rel. Lawyers Institute v. Merchants Protective Corp.*, 189 Cal. 531, 209 Pac. 363 (1922); *State ex rel. McKittrick v. C. S. Dudley & Co.*, 340 Mo. 852, 102 S.W.2d 895 (1937); *Matter of Co-operative Law Co.*, 198 N.Y. 479, 92 N.E. 15 (1910); *People v. Peoples Trust Co.*, 180 App. Div. 494, 167 N.Y. Supp. 767, 768 (2d Dep't 1917); *Hexter Title & Abstract Co. v. Grievance Comm.*, 142 Tex. 506, 179 S.W.2d 946, 157 A.L.R. 268 (1944); ABA Comm. on Professional Ethics, Opinion 10 (1926). But see Lewis, *supra* note 169, at 345.

all-lawyer association or corporation than they would be in a partnership. It would be unrealistic to assert that a partner or lawyer-employee of a partnership owes no allegiance to the partnership or other partners. Not all potential conflicts of interest are unethical,<sup>184</sup> and it would be impractical and undesirable to maintain that the general loyalties of an attorney to his partnership or corporation would interfere with the professional responsibilities to his client. Of course, a member or employee of a corporation or association, like one of a partnership, may not represent interests which would conflict with the interests of other clients of the organization.<sup>185</sup>

The personal relationship of attorney and client also encompasses the confidential nature of that relationship.<sup>186</sup> While all of the new statutes disclaim any intention to modify the rules governing the profession or the law applicable to the relationship between the professional and his client<sup>187</sup> a few of the acts go further and expressly provide that the confidential relationships now or hereinafter enjoyed shall remain inviolate.<sup>188</sup> This provision appears desirable since the question of privileged communication is one of law as well as ethics.<sup>189</sup> It should also be noted in this regard

<sup>184</sup> Canon 6 forbids representation of conflicting interests "except by express consent of all concerned given after a full disclosure of the facts." Even with such disclosure it may be improper to represent conflicting interests, but there are many occasions when disclosure or other practical considerations will justify representation despite a conflict of interests. See Cheatham, *Legal Profession* 155 (2d ed. 1955) (noting that there is an inescapable conflict of interest between a lawyer and his client in the matter of fees); Drinker, *supra* note 178, at 107-11, 120-22 (1953); ABA Comm. on Professional Ethics, *Opinion* 271 (1946). Cf., *Lalancé & Grosjean Mfg. Co. v. Haberman Mfg. Co.*, 93 Fed. 197 (S.D.N.Y. 1899); *Eisemann v. Hazard*, 218 N.Y. 155, 112 N.E. 722 (1916).

<sup>185</sup> Drinker, *supra* note 178, at 106; ABA Comm. on Professional Ethics, *Opinions* 103 (1933), 72 (1932), 50 (1931), 49 (1931), 33 (1931), *Informal Decision No. C-437*. See note 288 *infra*.

<sup>186</sup> See *People v. People's Trust Co.*, *supra* note 183; Drinker, *supra* note 178, at 104, 132-37; *Canons* 6, 37.

<sup>187</sup> E.g., *Okla. Stat. Ann. tit. 18, § 812* (1962). "This act does not alter any law applicable to the relationship between a person rendering professional services and a person receiving such services. . . ." *Ky. Rev. Stat. § 274.075* (1962). "This Act shall not alter any law applicable to, or otherwise affect the fiducial, confidential, or ethical relationship between a person rendering professional services and a person receiving such services." *Fla. Stat. Ann. § 62-7* (Supp. 1962). See notes 188, 238 *infra*. See also *Minn. Stat. Ann. § 319.20* (Supp. 1962) (limited to medical corporations) permitting investigations by the licensing board but making the records and information relating to services rendered to a patient immune from such inquiry and providing that all other information furnished shall be confidential between the board and the corporation concerned.

<sup>188</sup> *Ala. Laws* 1961, act 865, § 6:

This act does not modify any law applicable to the relationship between a person furnishing professional services and a person receiving such service . . . including the confidential relationship . . . if any, and all confidential relationships previously enjoyed under the Laws of this State or hereinafter enacted shall remain inviolate.

*N.J. Stat. Ann. § 14:19-8* (1963) and *Va. Code Ann. § 54-886* (Supp. 1962) are to the same effect. See *Colo. R. Civ. Proc., Rule 265 § II(D)* (Supp. 1961): "Nothing in this Rule shall be deemed to modify the attorney-client privilege specified in 1953 C.R.S. 158-1-7(2) and any comparable common law privilege."

<sup>189</sup> ABA Comm. on Professional Ethics, *Opinions* 247 (1942), 150 (1936); 8 *Wigmore, Evidence* §§ 2290-92 (McNaughton Rev. 1961). See Simon, "The Attorney-Client Privilege As Applied to Corporations," 65 *Yale L.J.* 953 (1956); 76 *Harv. L. Rev.* 655 (1963).

that a corporation is not entitled to invoke the privilege against self-incrimination and that corporate papers in the hands of its officers have been held not to be entitled to the protection of the privilege<sup>190</sup> However, partners may not be in any better position to invoke the self-incrimination privilege to protect partnership papers held by them.<sup>191</sup>

4. *Solicitation, Fee-Splitting and Related Evils.* Fear of unrestricted advertising and solicitation is another apparent justification for the rule that a corporation may not engage in the practice of law.<sup>192</sup> Attorneys who perform legal services for a corporation which is unlawfully practicing would be breaching their ethical responsibilities by receiving legal business through the corporation's solicitations, by sharing their professional fees with the lay corporation, and by aiding the unauthorized practice of law.<sup>193</sup>

Such evils will not exist in the professional corporation. Since only lawyers may own and perform professional services for the corporation,<sup>194</sup> there will be no sharing of fees with laymen, and the Canons of Ethics will operate on the members and employees, and in some states on the organization itself,<sup>195</sup> to prevent improper solicitation. Moreover, since the lawyers will be practicing in corporate form under legislative or judicial authority, they will not be engaged in, or aiding, the unauth-

<sup>190</sup> McCormick, Evidence § 125 (1954). See also note 189 supra on the applicability of the attorney-client privilege to corporations.

<sup>191</sup> See 8 Wigmore, Evidence § 2259a (McNaughton Rev. 1961); 1 Davis, Administrative Law 198-200 (1958).

<sup>192</sup> See State ex rel. McKittrick v. C. S. Dudley & Co., 340 Mo. 852, 102 S.W.2d 895, 901-02 (1937); Matter of Tutthill, 256 App. Div. 539, 102 N.Y.S.2d 643 (1st Dep't 1939); Note, 12 Stan. L. Rev. 746, 751 (1960); cf., People ex rel. State Board of Medical Examiners v. Pacific Health Corp., 12 Cal. 2d 156, 82 P.2d 429 (1938), cert. denied, 306 U.S. 633 (1939); Matter of Rothman, 12 N.J. 528, 97 A.2d 621 (1953); State ex rel. Lundin v. Merchants Protective Corp., 105 Wash. 12, 177 Pac. 694 (1919); ABA Comm. on Professional Ethics, Opinion 31 (1931); N.Y. Co. Lawyers' Ass'n Comm. on Professional Ethics, Opinion 47 (1914).

<sup>193</sup> Canons 27, 34, 47. See Matter of Maclub, 295 Mass. 45, 3 N.E.2d 272, 105 A.L.R. 1360 (1936); Matter of Schwartz, 175 App. Div. 335, 161 N.Y. Supp. 1079 (1st Dep't 1916); Matter of Newman, 172 App. Div. 173, 158 N.Y. Supp. 375 (1st Dep't 1916); Cases cited, notes 50, 85 supra; ABA Comm. on Professional Ethics, Opinions 294 (1958), 198 (1939), 122 (1934), 35 (1931), 31 (1931), 10 (1926), 8 (1925); ABA Comm. on Unauthorized Practice, Informative Opinion A of 1962, 28 U.P. News 36 (No. 2, 1962); N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinion 733 (1949); Conn. State Bar Ass'n Comm. on Professional Ethics, Opinion 5, 31 Conn. B.J. 144 (1957); N.Y. Co. Lawyers' Ass'n Comm. on Professional Ethics, Opinions 220 (1924), 136 (1917), 47 (1914); see also Matter of Schwartz, 195 App. Div. 194, 186 N.Y. Supp. 535 (1st Dep't 1921), aff'd, 231 N.Y. 642, 132 N.E. 921 (1921). Although a legal aid or lawyer reference service conducted by a bar association advertises its legal services, the usual evils of advertising and solicitation to aid individual lawyers and commercialize the profession are not present, and the society is not considered to be unlawfully practicing law. See Jacksonville Bar Ass'n v. Wilson, 102 So. 2d 292 (Fla. 1958); Azzarello v. Legal Aid Society of Cleveland (Ohio Ct. C.P., Jan. 4, 1962), 48 A.B.A.J. 382 (1962); ABA Comm. supra, Opinions 207 (1941), 205 (1940), 148 (1935); see also Opinions 291 (1956), 191 (1939).

<sup>194</sup> See note 172 supra.

<sup>195</sup> See notes 173-74 supra. Ky. Rev. Stat. § 274.085 (1962) expressly prohibits advertising contrary to the ethics of the profession.



orized practice of law. As a further guard against indirect solicitation, all of the states restrict the business of the organization to the rendering of the professional service for which it was created, thus preventing the organization from operating a business which could be used to feed its law practice.<sup>196</sup> Most of the acts, however, do permit the entity to invest its funds and own real and personal property used for the rendering of professional services.<sup>197</sup> The ownership of such property is, of course, a necessary incident to the practice of law, and the investments would be subject to the same limitations regarding conflicts of interest and solicitation that apply to individual practitioners or members of partnerships.<sup>198</sup>

<sup>196</sup> E.g., Ala. Laws 1961, act 865, § 4; Colo. R. Civ. Proc., Rule 265 § I(B) (Supp. 1961); Okla. Stat. Ann. tit. 18, §§ 806, 810 (Supp. 1962) also prohibit a person from being an officer, director, or shareholder of more than one professional corporation at the same time, and Fla. Stat. Ann. § 621-13 (Supp. 1962) and Ky. Rev. Stat. § 274.095 (1962) prohibit mergers and consolidations except with domestic corporations rendering the same type of professional services. See Kahn, *supra* note 156, at 74, interpreting the Wisconsin act as prohibiting investments by one professional corporation in another, but apparently not prohibiting one person from being a stockholder in more than one corporation as long as he was licensed to perform the services rendered by each. See also note 198 *infra*.

<sup>197</sup> E.g., Ala. Laws 1961, act 865, § 4: "However, it may invest its funds in real estate, mortgages, stocks, bonds, or any other type of investment, and may own real or personal property necessary or appropriate for rendering professional service." Okla. Stat. Ann. tit. 18, § 806 (Supp. 1962) is to the same effect. Va. Code Ann. § 54-381 (Supp. 1962):

Each professional association organized under the provisions of this chapter shall have power:

(d) To purchase, take by gift, devise or bequest, receive, lease, or otherwise acquire, own, hold, improve, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, in its own name.

(e) To sell, convey, mortgage, pledge, lease, exchange, transfer and otherwise dispose of all or any part of its property and assets.

(f) To make contracts and incur liabilities, borrow money at such rates of interest as its board of directors may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property and income.

...

(i) To pay pensions and establish pension plans, pension trusts, profit sharing plans, and other incentive plans for its associates, directors, officers and employees.

Compare Fla. Stat. Ann. § 621-8 (Supp. 1962) with N.J. Stat. Ann. § 14:19-9 (1963). All of the statutes except those of Connecticut, Ohio and Tennessee and the Colorado rule have provisions similar to the Alabama one. Even in the states lacking express provisions, the authority to own property and invest funds should be implied. This is especially true under acts granting general corporate powers or making the business corporation law applicable except when there is a conflict with the professional corporation act. See e.g., Colo. R. Civ. Proc., Rule 265 § I(C) (Supp. 1961); Ohio Rev. Code Ann. § 1785.08 (Anderson Supp. 1962). The "Model Act" permits the rendering of the professional service and "services reasonably related thereto" and provides that present practices should be used as a guide in determining what is reasonably related. Thus attorneys could continue to act as trustees. In addition, the corporation is permitted to "own" its business property and "invest" (not to the extent of a controlling interest) in any other property. Harvard Student Legislative Research Bureau, *supra* note 155, at 410.

<sup>198</sup> See *Matter of Rothman*, 12 N.J. 528, 97 A.2d 621 (1953); *Matter of L.R.*, 7 N.J. 390, 81 A.2d 725 (1951); *Matter of Schwartz*, 175 App. Div. 335, 161 N.Y. Supp. 1079 (1st Dep't 1916); ABA Comm. on Professional Ethics, *Opinions* 305 (1962), 297 (1961), 255 (1943, as modified, 1948), 225 (1941), 57 (1932), *Informal Decisions* 520, C-442, C-431, C-424, 37-46; Conn. State Bar Ass'n Comm. on Professional Ethics, *Opinion* 5 (1957), 31 Conn. B.J. 144 (1957); N.Y. Co. Lawyers Ass'n, *Comm. on Professional Ethics, Opinions* 322

The professional corporations and associations will no doubt want to take advantage of the tax benefits available by establishing a qualified pension or profit-sharing plan. An investment of this nature should not raise ethical problems,<sup>199</sup> but the ABA Committee on Professional Ethics in its Opinion 303 stated that it would violate Canon 34 prohibiting fee-splitting with a layman if non-lawyer employees were permitted to participate in a profit-sharing plan. Since this restriction may prevent an organization from qualifying its profit-sharing plan under the Internal Revenue Code, the major benefit of adopting the corporate or association form, and perhaps some of the minimal benefits which the ABA fought for under the Keogh Bill, may be lost to lawyers.<sup>200</sup> Despite the ABA Committee's acknowledgement in its recent opinion that "the substance of an arrangement is controlling, not the form," it is submitted that in this particular regard the Committee applied Canon 34 formalistically and mechanically. It is recognized by the opinion that the payment of regular compensation to lay employees out of fees derived from legal services does not violate Canon 34.<sup>201</sup> Even though this type of arrangement permits a non-lawyer to collect a portion of the lawyer's fees, to hold otherwise would prevent a legal secretary or clerk from ever being compensated for his or her lawful services. Canon 34 forbids the payment of legal fees to one who performs legal services without a license, solicits legal business or otherwise exploits the practice of law,<sup>202</sup>

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(1934), 260 (1928), 220 (1924), 179 (1919), 114 (1917), 47 I, III (1914); Drinker, *supra* note 178, at 221-28 (1953). See also ABA Special Comm. to Cooperate With the ABA Comm. on Professional Ethics Re Ass'n's Taxable As Corporations, ABA Section of Taxation Bull. 41, 53 (Oct. 1961); Buchmann & Bearden, *supra* note 156, at 9, 16. But cf., *Matter of Thibodeau*, 295 Mass. 374, 3 N.E.2d 749, 106 A.L.R. 1360 (1936), 31 Ill. L. Rev. 813 (1937).

<sup>199</sup> See notes 197 *supra*, 254 *infra*.

<sup>200</sup> See ABA Special Comm., *supra* note 198, at 53. Apparently the ABA opinion does not condemn a pension plan based on a fixed yearly contribution, but even such a contribution must be keyed to estimated earnings and if the estimate proves wrong, the tax laws allow for some adjustment. It may be that a profit-sharing plan can be devised which will have standards of participation that exclude nonlawyer employees but is still not discriminatory. See Spector, *supra* note 154. See also notes 50-53 *supra* and accompanying text; note 204 *infra*.

<sup>201</sup> This modifies a statement in Opinion 283 (1950) but is consistent with other opinions which of necessity, permit a lawyer to compensate out of his fees persons who perform nonlegal activities which constitute a part of the total services of the lawyer. See Opinions 297 (1961), 272 (1946) (accountant), 294 (1958), 48 A.B.A.J. 383 (1962), 180 (1938) (collection agency); 48 (1931) (patent attorney); Informal Decisions Nos. 344, 341, 326. See also N.Y. Co. Lawyers Ass'n Comm. on Professional Ethics, Opinions 220 (1924), 142 (1918). Apparently it makes a difference to some committees whether the compensation for a layman's nonlegal services is paid direct to the layman or included in the lawyer's fee and then paid to the layman by the lawyer. Compare N.Y. City Bar Ass'n, Comm. on Professional Ethics, Opinion 473 (1939) with Opinion 446 (1938). The latter situation comes within the literal wording of the Canon 34 prohibition but is no more within its intent than is the payment of a legal secretary's salary out of legal fees.

<sup>202</sup> See ABA Comm. on Professional Ethics, Opinions 272 (1946), 237 (1941), 56 (1931), 35 (1931), 32 (1931), 31 (1931), 8 (1925); N.Y. Co. Lawyers' Ass'n, Comm. on Professional Ethics, Opinions 562 (1941), 475 (1939), 47 II(a) (1914); Drinker, *supra* note 178, 179-80, 181-86 (1953); see also *Matter of Maclub*, 295 Mass. 45, 3 N.E.2d 272 (1936); Canons 12, 27, 28, 35, 47.

but it does not prohibit a lay employee from receiving a fair compensation based upon the value of the legitimate non-legal services performed and not on the size of the legal fees.<sup>203</sup> According to the New York County Lawyer's Association Committee on Professional Ethics, a bonus to employees based on net profits is not improper as long as there is no advance agreement to make the distribution.<sup>204</sup> Such an agreement, in the opinion of the Committee, is "inconsistent with the essential dignity of the profession, and is liable to be made the cloak for promoting the solicitation of employment for the office." The first reason assigned is difficult to understand and thus difficult to meet;<sup>205</sup> the second reason is understandable but answerable. Since an increase in the business of a law office is likely to result in higher wages or a year-end bonus for the employees, any encouragement to solicit would be present even without an agreement to share in the increased earnings. Would an employee need an advance agreement in order to act in anticipation of the usual consequences? In any event, the evil of solicitation can be guarded against through the disciplinary authority over an attorney who encourages or acquiesces in such conduct on the part of his employees.<sup>206</sup> If there are effective safeguards against aiding the unauthorized practice of law, solicitation, and exploitation of a lawyer's service, it would seem that reasonable contributions to a profit-sharing plan should not be condemned even though they are based on the net profits of the law firm. The evils which Canon 34 seeks to guard against are not present, and the determination of contributions on the basis of earnings is merely a method of keeping the expense of a plan within the bounds of what the firm can afford. Such plans are legitimate methods of compensation with the laudable objectives of increasing employee stability, efficiency and loyalty, and with the aid of a tax saving, helping to provide for the retirement needs of both professional and non-professional employees.<sup>207</sup>

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<sup>203</sup> See note 201 *supra*.

<sup>204</sup> Opinion 122 (1917). See Opinion 80 (1915) holding that it would be improper to pay a clerk bonuses from time to time based on the business which he attracts to the law office. Cf., ABA Comm. on Professional Ethics, Opinion 18 (1930). It has been suggested that a law firm could make voluntary payments to a profit-sharing fund without any agreement to do so. Bye & Young, *supra* note 156, at 456. But such an arrangement might fail to qualify as an approved plan under the tax laws, and would lack some of the nontax benefits of an agreed to plan.

<sup>205</sup> One cannot argue with the proposition that a loss in the dignity of the lawyer would injure the status and effectiveness of the profession, nor can it be denied that it would be undignified for a lawyer to enter into a contract to share legal fees with a layman who has unlawfully performed legal services, not performed any legitimate services, or merely solicited business. The essential dignity of the profession, however, would not seem to be injured by providing a fringe benefit to a law firm's employees in accordance with what the firm can afford on the basis of each year's earnings.

<sup>206</sup> See notes 172-74 *supra*.

<sup>207</sup> See ABA Comm. on Professional Ethics, Informal Decision 347: "An assignment by a partner of his interest in the partnership to himself and his wife by the entirety merely

In summary, the newly created professional entities appear to have avoided the usual objections to the practice of law by a corporation.<sup>208</sup> Although uncertainty exists as to some procedures which might be used by lawyers practicing in this form, it can not be said that an all-lawyer professional corporation or association is incapable of being used as a structure in which to practice law. It remains to be determined whether or not ethical considerations may nevertheless prevent the acquisition of the corporate characteristics required under the Kintner regulations.

### B. *The Corporate Characteristics Required By the Kintner Regulations*

1. *Associates and a Joint-Profit Objective.*<sup>209</sup> Although these characteristics may not be counted in judging the corporate resemblance of an organization, the absence of either of them will prevent the organization from being classed as an association. All but two of the association statutes require a minimum of two or three professional persons to form an association,<sup>210</sup> while most of the corporation statutes permit a professional organization to be formed by only one person.<sup>211</sup> Although the

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to save inheritance taxes, the wife being in no way involved in law practice or in any relationship with the clients, does not violate Canon 34." See also N.Y. City Bar Ass'n, Comm. on Professional Ethics, Opinion No. 591 (1941); note 99 supra. Some state courts may decline to follow the prohibition on lay-employee profit-sharing plans in the ABA Opinion 303. See Bye & Young, "Law Firm Incorporation in Colorado," 34 Rocky Mt. L. Rev. 427, 456 n.177a (1962). This portion of the ABA opinion came as a shock to many lawyers especially members of some large firms which for several years had had profit-sharing plans for their nonpartner or nonlawyer employees.

<sup>208</sup> Other objections such as the fear that professionals would try to limit their liability for their conduct will be discussed in conjunction with the characteristics required by the Kintner regulations, *infra*. The refusal to permit corporations to practice law has also been rationalized on the ground that it is against public policy. See Comment, 2 U. Chi. L. Rev. 119, 129 (1934); Note, 37 Notre Dame Law. 545, 551 (1962). This was no doubt true, but it should no longer be a valid objection if the reasons for such practice being against public policy have been removed and if the state legislature and/or judiciary has authorized such practice.

<sup>209</sup> Treas. Reg. §§ 301.7701-2(a)(2), (3) (1960). See Smith, "Associations Classified As Corporations Under the Internal Revenue Code," 34 Cal. L. Rev. 461, 469-509, 529-30 (1946).

<sup>210</sup> Connecticut (Conn. Gen. Stat. Ann. § 34-82 (1) (1962)) and Tennessee (Tenn. Code Ann. § 61-105(3) (Supp. 1962)) and Virginia (Va. Code Ann. § 54-875 (Supp. 1962)) require three or more persons. Alabama (Ala. Laws 1961, act 865, § 2), Georgia (Ga. Code Ann. § 84-4303 (1961)) and Illinois (Ill. Ann. Stat. ch. 106½, § 101 (Smith-Hurd 1962)) require at least two associates. S.C. Code § 56-1603 (1962) and Pa. Stat. Ann. tit. 14, § 197-13 (Supp. 1962) permit only one professional to form an association.

<sup>211</sup> Arizona (Ariz. Rev. Stat. Ann. § 10-908.1 (Supp. 1962)) requires two or more persons, while the following states require one or more: Fla. Stat. Ann. §§ 621.1, 5 (Supp. 1962); Ky. Rev. Stat. § 274.015(1) (1962); Mich. Stat. Ann. § 21.315(4) (Supp. 1962); N.J. Stat. Ann. §§ 14:19-1, -5 (1963); Ohio Rev. Code Ann. § 1785.02 (Anderson Supp. 1962); Okla. Stat. Ann. tit. 18, § 804 (Supp. 1962); Wis. Stat. Ann. § 180.99(2) (Supp. 1963). The Colorado court rule 265 does not explicitly provide for any minimum number of lawyers to form a corporation, but states that "Lawyers may form professional service corporations for the practice of law under the Colorado Corporation Code . . ." Colo. R. Civ. Proc., Rule 265 § I(A) (Supp. 1961). The use of the plural "lawyers" may imply more than one and the Corporation Code requires three or more persons to establish a corporation, Colo. Rev. Stat. Ann. § 31-1-2 (1953). But see Bye & Young, *supra* note 207, at 436-37 stating that the Colorado rule permits less than three shareholders. See Note, 31 U. Cinc. L. Rev. 71, 82-83 (1962) posing the possibility that a one-man Ohio association might qualify under the regulations. The note apparently overlooks the essentialness of the "associates" attribute to

"associates" requirement would not be met by a one-man organization, this would not preclude organizations of two or more persons in such states from qualifying under the regulations. If, however, a professional corporation was recognized under the tax laws as a corporation and not an association, it would be unnecessary to satisfy the requirement of having associates, and a sole practitioner could incorporate and seek tax benefits as an employee of his own corporation.<sup>212</sup>

All of the states concerned provide for the conduct of a professional business,<sup>213</sup> the gains therefrom to be divided among the members. A group of individual practitioners who continue to maintain their separate practices but form a loose-knit organization in the hopes of satisfying all but the centralized management requirements of the regulations, probably would still be prevented from qualifying as an association because they would not be engaged in a joint enterprise.<sup>214</sup>

2. *Continuity of Life.*<sup>215</sup> This characteristic will be present if the association is not dissolved by the death, insanity, bankruptcy, retirement, resignation or expulsion of any member. Local law—not the agreement of the members—determines whether or not dissolution occurs upon the happening of such an event. Consequently, a partnership organized under the Uniform Partnership Act or Uniform Limited Partnership Act lacks continuity of life because a partner may terminate the agency relationship in contravention of an agreement among the members.<sup>216</sup> Thus the regulations are concerned with the technical dissolution of the entity and not the more practical consideration that the enterprise may continue to exist uninterrupted by changes in membership.<sup>217</sup>

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classification as an association. The "Model Act" permits a one-man corporation so that he can get the same benefits nonprofessional incorporators could get by using "dummies" as additional incorporators. Harvard Student Legislative Research Bureau, "Incorporation of Professional Groups: A Model Act," 47 Mass. L.Q. 405, 406-07 (1962); see also note 234 *infra*.

<sup>212</sup> See *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949); Bittker, *Federal Income Taxation of Corporations and Shareholders* § 2.07 (1959); 1 O'Neal, *Close Corporations* 19 (1958); 2 *Id.* at § 8.17; Bye & Young, *supra* note 207, at 429; Kahn, "The Wisconsin Service Corporation Law of 1961," 1962 *Wis. L. Rev.* 65, 90. See also note 156 *supra*.

<sup>213</sup> For purposes of tax law classification, a profession is not distinguished from other types of businesses. See e.g., *Treas. Reg.* §§ 301.7701-2(g)(1), (2), (3) (1960).

<sup>214</sup> See Vesely, "The Ohio Professional Association Law," 13 *W. Res. L. Rev.* 195, 208 n.74 (1962); Note, 75 *Harv. L. Rev.* 776, 787 (1962).

<sup>215</sup> *Treas. Reg.* § 301.7701-2(b) (1960). See Smith, *supra* note 209, at 518-22; Ray, "Corporate Tax Treatment of Medical Clinics Organized As Associations," 39 *Taxes* 73, 79 (1961). A provision that the association will continue only for a stated period will not defeat continuity of life.

<sup>216</sup> See 7 *Unif. Laws Ann.* § 31, Commissioners' Note.

<sup>217</sup> See *Uniform Partnership Act* §§ 17, 27, 31, 41(1). This section of the regulation has been challenged as not being in accord with state interpretations of the *Uniform Partnership Act*. Maier & Wild, "Taxation of Professional Firms as Corporations," 44 *Marq. L. Rev.* 127, 138-39 (1960), and is inconsistent with some tax cases. See *United States v. Stierwalt*, 287 F.2d 855 (10th Cir. 1961) (continuity of life present because of improbability of dis-

All of the association statutes provide that the life of the association shall not be affected by such events as would have caused the dissolution of a partnership.<sup>218</sup> New Jersey and Wisconsin are the only corporation states which expressly provide that professional corporations shall have perpetual existence,<sup>219</sup> but the continuity of life of the other states' professional corporations can be implied from the nature of the corporate entity and from the applicability of the business corporation acts of the respective states.<sup>220</sup>

solution although members have right to dissolve); *Bye & Young*, supra note 207, at 432-33; *Sneed*, "More About Associations in the Oil and Gas Industry," 33 *Texas L. Rev.* 168, 188-89 (1954). Certain provisions of the Internal Revenue Code do not consider a partnership terminated where the enterprise continues unless there has been a sale or exchange of at least half of the total interest in the partnership. IRC §§ 706(c), 708. See *Carrington & Sutherland*, *Articles of Partnership for Law Firms* 34-35; *ABA Economics of Law Practice Series*, Pamphlet No. 6 (1961); *Comment*, 16 *Sw. L.J.* 462, 469, 480 (1962).

Realistically viewed a partnership may have as much continuity of life as does a corporation, since a corporation can often be dissolved by shareholders holding a sufficient percentage of the stock, and a partner is not likely to dissolve a partnership in contravention of his agreement because of the deterrent effect of damage suits. See *Bittker*, supra note 212, at 30 (1959); *Note*, 12 *Stan. L. Rev.* 746, 760 (1960). The continuity of life of a close corporation is especially shaky. And see 2 *O'Neal*, supra note 212, at §§ 9.06, 9.18, 9.26-29.

<sup>218</sup> Ala. Laws 1961, act 865, § 8:

Unless the articles of association expressly provide otherwise, a professional association shall continue as a separate entity independent of its members or shareholders, for all purposes for such period of time as provided in the articles, or until dissolved by a vote of two-thirds of the members, and shall continue notwithstanding the death, insanity, incompetency, conviction for felony, resignation, withdrawal, transfer of membership or ownership of shares, retirement, or expulsion of any one or more of the members or shareholders, the admission of or transfer of membership or shares to any new member or members or shareholder or shareholders, or the happening of any other event, which under the law of this State and under like circumstances, would work a dissolution of the partnership, it being the aim and intention of this section that such professional association shall have continuity of life independent of the life or status of its members or shareholders. No member or shareholder of a professional association shall have the power to dissolve the association by his independent act of any kind.

Ill. Ann. Stat. ch. 106½, § 107 (*Smith-Hurd* 1962); Va. Code Ann. § 54-887 (Supp. 1962) are to the same effect. See also Conn. Gen. Stat. Ann. § 34-82(1)(a) (1962); Pa. Stat. Ann. tit. 14, § 197-14 (Supp. 1962); Tenn. Code Ann. § 61-105(3)(a) (Supp. 1962). Pennsylvania (Pa. Stat. Ann. tit. 14, § 197-19 (Supp. 1962)) permits dissolution by a majority (or greater percentage provided for in the by-laws) vote of the outstanding ownership shares.

<sup>219</sup> N.J. Stat. Ann. § 14:19-13(a) (1963); Wis. Stat. Ann. § 180.99(10)(a) (Supp. 1963). Arizona (Ariz. Rev. Stat. Ann. § 10-908.2 (Supp. 1962)) requires a stated term of existence of not more than twenty-five years which term may be renewed. This requirement will not defeat continuity of life. See note 215 supra.

<sup>220</sup> Colo. R. Civ. Proc., Rule 265 § I (Supp. 1961): "Lawyers may form professional service corporations for the practice of law under the Colorado Corporation Code, providing that such corporations are organized and operated in accordance with the provisions of this Rule." Colo. R. Civ. Proc., Rule 265 § I(C) (Supp. 1961): "The corporation may exercise the powers and privileges conferred upon corporations by the laws of Colorado only in furtherance of and subject to its corporate purpose." Okla. Stat. Ann. tit. 18, § 805 (Supp. 1962): "The Business Corporation Act shall be applicable to Professional Corporations and they shall enjoy the powers and privileges and be subject to the duties, restrictions and liabilities of other corporations, except where inconsistent with the letter and purpose of this Act. This Act shall take precedence in the event of any conflict with provisions of the Business Corporation Act or other laws." See also Ariz. Rev. Stat. Ann. §§ 10-904, -908.3(b) (Supp. 1962); Fla. Stat. Ann. § 261.13 (Supp. 1962); Ky. Rev. Stat. § 274.015(2) (1962); Ohio Rev. Code Ann. § 1785.08 (Anderson Supp. 1962); Wis. Stat. Ann. § 180.99(3) (Supp. 1963). (E.g., perpetual existence is granted corporations in Ohio by Ohio Rev. Code Ann. § 1701.10 (Page 1954)). The Kentucky statute also provides for the termination of the corporation if the outstanding shares of a deceased, disqualified or otherwise withdrawing member

The continuity of life of an organization may be endangered by the uniform requirement in all states that all members or shareholders be qualified to practice the profession. In order to prevent an interest from passing to an unqualified person, which in turn could cause dissolution of the organization,<sup>221</sup> the articles of association or incorporation, or the statute itself (as has been partially provided in some states), should require the organization to purchase the interest of a deceased, disqualified, resigned, expelled or inactive member whenever the interest has not been transferred to a qualified professional within a stated reasonable period of time.<sup>222</sup> To avoid dissolution upon the death or disqualification of the

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are not transferred to a qualified person or redeemed by the corporation (Ky. Rev. Stat. §§ 274.095(1), (5) (1962)) or if such redemption renders the corporation insolvent (Ky. Rev. Stat. § 274.095(6) (1962)). See note 174 *supra*.

<sup>221</sup> See note 174 *supra*; Bittker, "Professional Associations and Federal Income Taxation: Some Questions and Comments," 17 *Tax L. Rev.* 1, 15 (1962). In some states, however, dissolution of the corporation may not be required because a shareholder becomes disqualified. See *Bye & Young*, *supra* note 209, at 441; *Vesely*, *supra* note 214, at 208-09; note 224 *infra*. See also note 225 *infra*.

<sup>222</sup> See e.g., Ala. Laws 1961, act 865, § 9:

Subject to the provisions of the articles of association, the estate of a member or shareholder who was a person duly licensed or otherwise legally authorized to render the same professional service as that for which the professional association was organized may continue to hold stock or membership pursuant to the articles of association for a reasonable period of administration of the estate, but shall not be authorized to participate in any decisions concerning the rendering of professional service.

Ala. Laws 1961, act 865, § 11 provides a method for setting the price at which shares of a deceased, retired, expelled or disqualified member may be purchased by the association or its members. Other acts contain provisions of a similar nature. *Ariz. Rev. Stat. Ann.* § 10-909(D) (Supp. 1962); *Ky. Rev. Stat.* § 274.095(1) (1962); *N.J. Stat. Ann.* §§ 14:19-10, 13(c) (1963); *Okl. Stat. Ann.* tit. 18, § 815 (Supp. 1962); *Wisc. Stat. Ann.* § 180.99(10c) (Supp. 1963); see *Harvard Student Legislative Research Bureau*, *supra* note 211, at 414-16. Florida (*Fla. Stat. Ann.* § 621.11 (Supp. 1962)) permits purchase or redemption of its shares by the corporation as long as its capital will not be impaired. *Colo. R. Civ. Proc.*, Rule 265 § 1(E) (Supp. 1961) requires that provision be made for a disqualified shareholder to dispose of his shares to the corporation or to any qualified person. See *Note*, 37 *Notre Dame Law.* 545, 548 (1962) stating that a deceased or otherwise withdrawing member's interest must be redeemed but that such a requirement would prevent free transferability of interests. But see discussion at notes 268-73 *infra*. *Bittker*, *supra* note 221, at 15-17 maintains that a repurchase agreement would be inadequate to save the continuity of the entity because the organization might lack funds to repurchase, be prohibited from doing so, or otherwise not act within the required time. However, restrictions on the purchase of a corporation's own stock should not apply since they would be in conflict with the provisions of the professional corporation acts which authorize such purchase and which usually provide that the business corporation acts will not be applicable where they conflict with the professional corporation act. See *Harvard Student Legislative Research Bureau*, *supra* at 409. In addition *Okl. Stat. Ann.* tit. 18, § 815 (Supp. 1962) expressly provides that restrictions on the repurchase of a corporation's shares shall not apply to professional corporations, and *Pennsylvania (Pa. Stat. Ann.* tit. 14, § 197-13 (Supp. 1962)) and *Virginia (Va. Code Ann.* §§ 54-889, -891 (Supp. 1962)) give their associations the power to redeem the interests of associates while *Arizona (Ariz. Rev. Stat. Ann.* § 10-908(6) (Supp. 1962)) permits transfer of shares to the corporation. But see *Vesely*, *supra* note 214, at 200 suggesting that while an Ohio association can redeem and retire its own shares it may not be able to purchase them. The organization should of course maintain sufficient funds with which shares can be repurchased. It might be wise to require some paid-in capital or reserve for this purpose. See *Harvard Student Legislative Research Bureau*, *supra* at 408. If an organization fails to repurchase shares as required, it would seem that it could be compelled to do so at the instance of a shareholder's court action, or it could be dissolved. But the latter remedy would not necessarily destroy continuity of life under the *Kintner* regulations. See note 221 *supra*; note 225 *infra*.

last surviving member,<sup>223</sup> the statute could permit a disqualified member or the estate of a deceased member to transfer ownership to a qualified person, or permit the estate of the last member to convert the organization into a general purpose corporation.<sup>224</sup> In any event it would seem that continuity of life does not require that the organization not be dissolvable under any circumstances but only that it not be dissolved by those events which would normally terminate a partnership. This much the state statutes clearly provide.<sup>225</sup>

Continuity of the life of the entity may also involve continuity of its name. The use of a deceased member's name may be in violation of Cannon 33 unless such use is permitted by local custom and is not misleading.<sup>226</sup> Furthermore, the use of designations such as "Company" or "Associates" and other trade names has been considered improper.<sup>227</sup>

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<sup>223</sup> A few acts expressly provide that the entity shall be dissolved upon the death of the last surviving member. Ariz. Rev. Stat. Ann. § 10-908(3) (Supp. 1962); Ky. Rev. Stat. § 274.095(3) (1962). As a practical matter this would only be a problem in those states permitting a sole practitioner to form an association or corporation. See Note, 31 U. Cinc. L. Rev. 71, 82-83 (1962). By analogy, a closely held corporation is classified as a corporation for tax purposes even though its existence may terminate upon the death of its owner-manager. See notes 212, 217 *supra*.

<sup>224</sup> The right of a disqualified member or the estate of a deceased member to transfer interests held in the organization exists expressly or impliedly in the provisions of the acts permitting redemption of such interests. See note 222 *supra*. In addition, Pa. Stat. Ann. tit. 14, §§ 197-12, -18 (Supp. 1962) expressly allows a disqualified associate who has been expelled or a personal representative of an associate's estate to transfer his interest. N.J. Stat. Ann. § 14:19-13(b) (1963) and Wis. Stat. Ann. § 180.99(10)(b) (Supp. 1962) automatically convert a professional corporation into a business corporation when no qualified stockholder remains, and the Attorney General of Florida is of the opinion that it would not be improper to permit the inheriting shareholders of a sole owner of a professional corporation to amend the articles of incorporation to convert the entity into a general corporation. Op. Atty. Gen. of Fla. 061-139, Sept. 12, 1961, reported in *New Professional Corporation Laws Explained*, CCH 1962 Stand. Fed. Tax Rep. No. 8, Pt. I, ¶ 549.

Pending transfer or redemption of an interest, or conversion of the purpose of the corporation, it is of course necessary to provide that the estate of a deceased member, or a disqualified member, shall not participate in any decisions concerning the rendering of professional services, or share in the future professional earnings of the organization. See notes 271-74 *infra* and accompanying text.

<sup>225</sup> A business corporation can also be dissolved for abuse of its powers or unauthorized acts. See Stevens, *Private Corporations* 951-54 (2d ed. 1949); Grayck, "Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments," 17 *Tax L. Rev.* 469, 481-82 (1962); note 173 *supra*. Moreover, the dissolution of a corporation or of a professional association is brought about by independent action such as quo warranto proceedings, not by the unauthorized act itself. See Bye & Young, *supra* note 207, at 440-41; Comment, 16 *Sw. L.J.* 462, 482 (1962).

<sup>226</sup> ABA Comm. on Professional Ethics, Opinions 267 (1945), 258 (1943), 208 (1940); Informal Dec. Nos. 598 (1962), 541 (1962); see *Mendelsohn v. Equitable Life Assur. Soc.*, 178 *Misc.* 152, 33 *N.Y.S.2d* 733 (App. Term 2d Dep't 1942); ABA Comm., *supra*, Opinion 97 (1933) stating that where the custom is that the firm name does not necessarily identify the firm members, a former partner's name may continue to be used. The Wisconsin statute (Wis. Stat. Ann. § 180.99(4) (Supp. 1963)) permits the use of a former member's name. The Arkansas (Ark. Stat. Ann. § 67-1704 (1961)) and South Dakota (S.D. Laws 1961, ch. 29, § 4) medical corporation acts provide that the name of a deceased member may be carried for no more than a year after his death. Florida has made Canon 33 expressly applicable to the professional corporation, but permits it to adopt a fictitious name when authorized by the professional incorporation act. *Matter of The Florida Bar*, 133 *So. 2d* 554, 559 (Fla. 1961).

<sup>227</sup> ABA Committee on Professional Ethics, Opinion 219 (1941); Informal Opinions 373-77; *Drinker*, *supra* note 178, at 206-07 (1953).



On the other hand, it is also improper to use a partnership name when in fact a partnership does not exist.<sup>228</sup> Taken in total these prohibitions would prevent a professional corporation from adopting a name since it could not identify itself as a corporation for fear of using a trade name, but it would be misleading if a partnership name were adopted. Since these new state acts now permit lawyers to incorporate or form associations, it should no longer be improper to use designations which properly identify the entities. Accordingly, provisions of the acts permit or require the use of designations as "associated," "professional association," "chartered" or abbreviations thereof.<sup>229</sup> The name should indicate the type of firm a person is dealing with, especially if liability is limited in any degree.<sup>230</sup>

3. *Centralization of Management.*<sup>231</sup> To have this characteristic, the regulations require that the authority to make management decisions be vested continuously and exclusively in one or more persons but less than all the members, that these persons must do more than perform minis-

<sup>228</sup> ABA Committee on Professional Ethics, Opinions 277 (1948), 126 (1935); 115 (1934), 106 (1934); N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinion 607 (1942); Drinker, supra note 178, at 204-08. The acts of Florida (Fla. Stat. Ann. § 621.12 (Supp. 1962)) and Kentucky (Ky. Rev. Stat. Ann. § 274.075 (1962)) permit their corporations to practice under the names of one or more members without a designation of the corporation status if such name is registered. Registration of a trade name by a law firm would appear to be insufficient protection in view of the long tradition of firm names being used to designate full liability partnerships. See notes 251-53 *infra* and accompanying text.

<sup>229</sup> Ariz. Rev. Stat. Ann. §§ 10-906(A), (B) (Supp. 1962) (full or last name of one or more shareholders or a fictitious name if not prohibited by the profession's canons of ethics, plus "professional corporation," "P.C.," "Limited," "Ltd.," "Professional Association," "P.A.," "Chartered"); Ala. Laws 1961, act 865, § 3; Ga. Code Ann. § 84-4304 (1961) and S.C. Code § 56-1604 (1962) ("Professional Association," "P.A."); (Colo. R. Civ. Proc., Rule 265 § I(A) (Supp. 1961)) ("professional company," "professional corporation" or abbreviation thereof, Canon 33 applies); Fla. Stat. Ann. § 621.12 (Supp. 1962); Mich. Stat. Ann. § 21.315(11) (Supp. 1962) and N.J. Stat. Ann. § 14:19-14 (1963) (with minor differences) (last names of some or all of the stockholders, plus "chartered," "professional association," "P.A.," but not "company," "corporation," "incorporated" or other similar word or abbreviation); Ill. Ann. Stat. ch. 106½, § 103 (Smith-Hurd 1962) (full or last name of one or more members, plus "associated," "association," "and associates" or "assoc."); Ky. Rev. Stat. § 274.075 (1962) (last name of two or more shareholders (except for single owner corporations), plus "chartered," "professional service corporation," "P.S.C."); Okla. Stat. Ann. tit. 18, § 807 (Supp. 1962) ("corporation," "incorporated," "corp.," "inc." subject to further requirement of regulating board of profession); Tex. Civ. Stat. Ann. art. 6132b § 6(3a) (1962) ("association," "associates"); Wis. Stat. Ann. § 180.99(4) (Supp. 1963) (last name of one or more present or former associates, or other name if recorded, plus "Chartered," "Limited," "Ltd.," "Service Corporation," "S.C.)."

<sup>230</sup> See notes 252-53 *infra* and accompanying text.

<sup>231</sup> Treas. Reg. § 301.7701-2(c) (1960). See Ray, supra note 215, at 80; note 244 *infra*; Smith, supra note 209, at 513-18. Under these provisions it would seem impossible for a one-man association or corporation (if it were subject to the regulations) to possess this characteristic. The regulations permit a limited partnership to qualify for this characteristic if substantially all of the interests are owned by limited partners. This would not aid the lawyer but may prove to be a help to the IRS in classifying as associations organizations developing mineral interests. See notes 304-05 *infra*.

It has been suggested that even a corporation does not give "exclusive" authority to its board of directors to make all the management decisions and other individuals frequently make day-to-day operational decisions which are potentially binding. Note, 12 Stan. L. Rev. 746, 760 (1960). See note 243 *infra*.

terial tasks such as presiding at meetings, and that their decisions should not require the ratification of the other members. In addition, no individual member should be able to bind the association by his acts. The regulations specify that a partnership governed by the Uniform Partnership Act would not qualify because the acts of one partner could bind all, notwithstanding a partnership agreement to the contrary since such agreement would not be binding on persons dealing with the partnership without notice of the restriction.

All of the association statutes provide for a governing group to manage the affairs of the association,<sup>232</sup> and several of the states expressly restrict the authority of individual members to bind the association.<sup>233</sup> With the exception of Arizona, the states authorizing professional corporations do not expressly provide for centralization of management since such characteristic would be possessed by reference to the applicable business corporation acts.<sup>234</sup>

Because an attorney may have a professional obligation to exercise his own discretion in certain matters such as what clients he will represent and what causes he will bring or contest,<sup>235</sup> it has been questioned

<sup>232</sup> E.g., Ala. Laws 1961, act 865, § 7:

A professional association organized pursuant to the provisions of this act shall be governed by a board of governors elected by the members or shareholders, and represented by officers elected by the board of governors, so that centralization of management will be assured, and no member shall have the power to bind the association within the scope of the association's business or profession merely by virtue of his being a member or shareholder of the association.

Va. Code Ann. § 54-882 (Supp. 1962):

A professional association organized pursuant to the provisions of this chapter shall be governed by a board of directors, which shall be elected by the associates from their own number and shall have the full management of the business and affairs of the association and continuing exclusive authority to make management decisions on its behalf, and no associate shall have the power to bind the association within the scope of its business or profession merely by virtue of his being an associate . . . [T]he number of directors shall be three, except that if the total number of associates is less than four, the number of directors shall be two.

(3 or more persons are required to form an association in Virginia, Va. Code Ann. § 54-875 (Supp. 1962)). See also note 234 *infra*.

<sup>233</sup> Note 232 *supra*; Conn. Gen. Stat. Ann. § 34-82(1b) (1962); Ill. Ann. Stat. ch. 106½, § 108 (Smith-Hurd 1962).

<sup>234</sup> Ariz. Rev. Stat. Ann. § 10-908(4) (Supp. 1962) provides for a board of directors, officers and an executive committee. In addition to making the business corporation laws applicable (see note 220 *supra*), several of the statutes make reference to a board of directors or other governing body. E.g., Colo. R. Civ. Proc., Rule 265 § I(D) (Supp. 1961), Fla. Stat. Ann. § 621.11 (Supp. 1962), Mich. Stat. Ann. § 21.315(12) (1962), N.J. Stat. Ann. § 14:19-6 (1963), Okla. Stat. Ann. tit. 18, § 810 (Supp. 1962). Ohio Rev. Code Ann. § 1701.63(A) (Anderson Supp. 1962) provides that its business corporations shall be managed by a Board of Directors of not less than three persons. The "Model Act" which provides for a one-man corporation also permits a professional corporation of less than four members to have a board of directors of less than three members notwithstanding the requirements of the business corporation act. Harvard Student Legislative Research Bureau, *supra* note 211, at 407-09. Michigan (Mich. Stat. Ann. § 21.315(12) (Supp. 1962)) and New Jersey (N.J. Stat. Ann. § 14:19-6 (1963)) permit one or more directors depending on the number of shareholders.

<sup>235</sup> Canon 31; ABA Comm. on Professional Ethics, Opinion 10 (1926); N.Y. Co. Lawyer's Ass'n Comm. on Professional Ethics, Opinion 251 (1927); ABA Special Comm., *supra* note 198, at 41, 50-52. Drinker, *supra* note 198, at 160-61.

whether he can transfer this responsibility to a governing board.<sup>236</sup> It is clear that a lawyer may not delegate his confidence, responsibility or functions to a layman,<sup>237</sup> but there does not appear to be any ethical objection to delegation to an attorney, who retains responsibility for his acts, working under the supervision of another attorney whose conduct is also subject to the same restrictions and who possesses the same professional obligations and privileges.<sup>238</sup> Indeed, several existing law partnerships have management committees which supervise, in addition to administrative matters, functions such as the acceptance of clients and the character and quality of the legal service rendered.<sup>239</sup> Difficulties may be encountered, however, in those states which permit non-professionals to hold management positions.<sup>240</sup> While a non-lawyer's func-

<sup>236</sup> See ABA Special Comm., *supra* note 198; Bittker, *supra* note 221, at 13-15, 23.

<sup>237</sup> ABA Comm. on Professional Ethics, Opinions 303 (1961), 85 (1932), 68 (1932), 8 (1925); Drinker, *supra* note 198.

<sup>238</sup> ABA Comm. on Professional Ethics, Opinions 303 (1961), 97 (1933), 68 (1932); Alabama Bar Ass'n Special Comm. Rep., "A Study of the Practical Ethical Considerations as to the Alabama Professional Association Act," 14 Ala. L. Rev. 79, 83-84; Bye & Young, *supra* note 207, at 441-42; Grayck, *supra* note 225, at 479; cf., Canon 34; ABA Comm. on Professional Ethics, Opinion 204 (1940). The duty to preserve the client's confidences, imposed by Canon 37 and the laws of the several states, would apply to all lawyers including managers, entering into a professional relationship with the client. See ABA Comm. on Professional Ethics, Opinion 303 (1961); Alabama Bar Ass'n, *supra*; American Bar Foundation Research Memo. No. 28, "Ethical Problems Raised by the Association and Incorporation of Lawyers," 17 (Greenwood, Research Att'y 1961); Note, 31 U. Cinc. L. Rev. 341, 346 (1962).

<sup>239</sup> See partnership agreement provisions based on national survey in Carrington & Sutherland, *supra* note 217, at 20-21, 86-96; see also ABA Comm. on Professional Ethics, Opinion 303 (1961); ABA Special Comm., note 198 *supra*; Comment, 16 Sw. L.J. 462, 484 (1962). The Texas Uniform Partnership Act contains provisions sanctioning existing classifications of partners such as senior, junior, and managing, and permits agreements to establish various classes of nonpartner employees. (This latter provision was intended to permit certain persons who share in the profits to be treated as employees rather than partners in order to seek tax benefits.) Tex. Civ. Stat. Ann. art. 6132b §§ 18(2), 18(3) (1962); Bromberg, "Texas Uniform Partnership Act—The Enacted Version," 15 Sw. L.J. 386, 390-91 (1961).

<sup>240</sup> See ABA Comm. on Professional Ethics, Opinion 303 (1961); Alabama Bar Ass'n, *supra* note 238, at 83; Comment, 16 Sw. L.J. 462, 483, 501-02 (1962). Such states include: Ala. Laws 1961, act 865, § 7:

Members of the board of governors need not be members or shareholders of the professional association and officers need not be members of the board of governors except that the president shall be a member of the board of governors, provided that no officer or member of the board of governors who is not duly licensed to practice the profession for which the professional association was organized shall participate in any decisions constituting the practice of said profession.

Colo. R. Civ. Proc., Rule 265 § I(F) (Supp. 1961): "The president shall be a shareholder and a director, and to the extent possible all other directors and officers shall be persons having the qualifications described in paragraph D above [Colorado lawyers]. Lay directors and officers shall not exercise any authority whatsoever over professional matters." See Bye & Young, *supra* note 207, at 436-37. N.J. Stat. Ann. § 14:19-6 (1963) and Wis. Stat. Ann. § 180.99(7) (Supp. 1963) (for one-man corporations only). Compare Okla. Stat. Ann. tit. 18, § 810 (Supp. 1962): "No person may be an officer, director, or shareholder of a professional corporation who is not an individual duly licensed to render the same specific professional services as those for which the corporation was organized." The Florida Supreme Court has required directors to be lawyers and executive officers to be shareholders. Matter of The Florida Bar, 133 So. 2d 554, 557-58 (1961). See Note, 31 U. Cinc. L. Rev. 341, 345-46 (1962) contending that a requirement that directors be lawyers is implied from the Ohio act provision that professional services only be rendered by licensed officers, employees and agents.

tions might be limited to housekeeping matters, this would appear to be insufficient to satisfy the regulations which require that authority to make the "business decisions" be vested in the central managers.<sup>241</sup> Since such decisions may well include ones of a professional nature, it would be advisable to employ only professionally qualified persons as managers. Furthermore, to avoid a charge of unauthorized practice of law or fee-splitting, or that the central managers constitute an intermediary exploiting or controlling the services of the lawyer employees, the members of the management committee should also be members or shareholders in the organization.<sup>242</sup> The restrictions of Canon 33 which prohibit partnerships with non-attorneys should also serve to prohibit a layman from becoming a member or a manager in a professional association or corporation.

Practical and ethical objections to the relinquishment of decision-making authority could also be minimized by vesting the management in a rotating committee of members who would then delegate authority to the lawyer employees to exercise their own discretion in accordance with general policies adopted by the managers. The lawyer employee could make decisions which would bind the organization, but only because he had been delegated the authority to do so, not because he was a member of the organization. Business corporations frequently delegate broad decision-making authority to certain of their employees, and a professional employee of a business corporation would normally enjoy sufficient freedom to exercise his professional prerogatives.<sup>243</sup>

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Many states fail expressly to permit or prohibit lay directors, e.g., Connecticut and Tennessee, while Pa. Stat. Ann. tit. 14, § 197-6 (Supp. 1962) provides that members of the board of governors need not be associates. This provision seems unwise since a non-associate manager (although prohibited from rendering professional services if he is a layman) might exploit legal services in violation of Canon 35 or share in professional fees in violation of Canon 34. See Note, 35 Temp. L.Q. 312, 317 (1962). By contrast, Ill. Ann. Stat. ch. 106½, § 108 (Smith-Hurd 1962) provides that: "Officers and members of the Board of Directors or Executive Committee shall be members of the professional association." And Va. Code Ann. § 54-882 (Supp. 1962) requires members of the board of directors to be associates, and (§ 54-883) requires all associates to be employees. Since all states require associates and shareholders to be qualified professionals, requiring the board members to be associates or shareholders prevents laymen from holding such positions. It also seems advisable to require all associates to be employees in order to avoid a division of fees not based upon a division of service or responsibility. Canon 34; ABA Special Comm. supra note 198, at 52-53; N.Y. Co. Lawyer's Ass'n, Comm. on Professional Ethics, Opinion 170 (1919) (improper for partnership to continue with dormant partner who shares in fees and formal responsibility only); see note 257 infra.

<sup>241</sup> Treas. Reg. § 301.7701-2(c)(3); ABA Special Comm. supra note 235 at 50-51; Bittker, supra note 236 at 13-15.

<sup>242</sup> Canons 34, 35, 47; ABA Comm. on Professional Ethics, Opinions 303 (1961), 272 (1946), 237 (1941), 32 (1931), 10 (1926), 8 (1925); ABA Report, supra note 235; Alabama Bar Ass'n, supra note 238; note 240 supra. See also note 165 supra.

<sup>243</sup> See Grayck, supra note 225, at 479-80; see note 61 supra. The daily operation of a corporation necessarily requires persons other than the board of directors to make binding business decisions. See Vesely, supra note 214, at 209-10; Note, 12 Stan. L. Rev. 746, 760-61 (1960). But cf. Bye & Young, supra note 207, at 442-43 questioning the effect of a board of

While a large law firm would have little problem in adopting or maintaining centralized management, a small firm which was unable or unwilling to employ "junior members" might find that none of its present partners will consent to give up, even temporarily, any of their authority over the affairs of the organization.<sup>244</sup> Thus the greatest road block to attaining this attribute may not be law or ethics but human nature.

4. *Limited Liability*.<sup>245</sup> The Kintner regulations provides that limited liability will exist when no member of the organization is personally liable under local law for the debts of or claims against the organization, that is, when a creditor cannot seek personal satisfaction from a member of the organization if its assets prove insufficient to satisfy his claim. Limited liability does not exist in a partnership governed by the Uniform Partnership Act.

In order to eliminate the possibility that professionals may use the corporate form to avoid personal responsibility for their acts, a few states have clearly sacrificed this corporate characteristic and have preserved joint and several liability as in a partnership.<sup>246</sup> Most states, however, have attempted both to satisfy the Kintner regulations and retain sufficient personal liability to meet professional standards. While these two objectives may at first appear inconsistent, they can be rationalized. Although it is true that a shareholder in a business corporation is ordinarily liable only to the extent of his capital contribution,<sup>247</sup> when the

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directors which delegates powers to employees but never exercises its retained ultimate authority. See note 244 *infra*.

<sup>244</sup> See Bye & Young, *supra* note 207, at 451-52; Note, 75 Harv. L. Rev. 776, 781-82, 786-87 (1962). It may be the actual contemplation of the members not the formal arrangement which controls. See *United States v. Stierwalt*, 287 F.2d 855 (10th Cir. 1961).

<sup>245</sup> Treas. Reg. § 301.7701-2(d) (1960). See Ray, *supra* note 215, at 80-81; Smith, *supra* note 209, at 525-27. Limited liability may exist in a limited partnership under circumstances not applicable to the practice of law.

<sup>246</sup> Pennsylvania makes all the associates jointly and severally liable for (1) the torts of any agent or employee committed while acting in the ordinary course of the operations of the association, (2) the misapplication by an associate of the money or property of a third person which was received by the association in the ordinary course of its operation, and (3) the debts and obligations of the association which remain unsatisfied upon dissolution; and the associates are jointly liable for all other debts and legal obligations of the association. Pa. Stat. Ann. tit. 14, §§ 197-17, -19(b) (Supp. 1962); see Note, 35 Temp. L.Q. 312, 315, 318-19 (1962). Arizona provides that the liability arising from the rendering of professional services shall not be altered, and that the shareholders shall be jointly and severally responsible for such liability, Ariz. Rev. Stat. Ann. § 10-905 (Supp. 1962). But the private property of the shareholders shall otherwise be exempt from liability for the debts of the corporation. Ariz. Rev. Stat. Ann. § 10-908(5) (Supp. 1962).

<sup>247</sup> There are several business corporations in which the shareholders do not enjoy complete limited liability. See e.g., 13A Fletcher, *Cyclopedia Private Corporations* §§ 6219, 6224 (1961). The concept of limited liability is neither essential to the existence of a state corporation nor to a corporation for tax purposes. Stevens, *supra* note 225, § 4, at 18-19; Conway, "The New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures," 30 *Fordham L. Rev.* 297, 298-99 (1961); Smith, *supra* note 209, at 533; Sneed, *supra* note 217, at 191. The latter article reported the results of a survey of 84 cases holding organizations taxable as corporations. Only 45 of the organizations in question possessed limited liability as compared with 100% having associates, a joint profit objective, continuity of life and

shareholder is also an employee of the corporation, he may be personally liable for his own negligence and misconduct. Accordingly, several states have stated their intention not to modify any law applicable to the relationship between a professional and his client or patient including the liability arising out of the rendering of professional services, but have also expressly or impliedly denied personal liability of the members for the debts or claims against the association.<sup>248</sup> These provisions probably do not retain partnership-type liability, but on the other hand, if construed to retain more than just a member's personal liability for his tortious conduct, neither will they satisfy the regulations.<sup>249</sup> Those states

centralization of management. See e.g., *Cooper v. Commissioner*, 262 F.2d 530 (10th Cir. 1958), cert. denied, 359 U.S. 944 (1959).

<sup>248</sup> The provisions vary somewhat from state to state and will likely be construed by the state courts as preserving different degrees of personal liability. E.g., Ala. Laws 1961, act 865, § 6:

This act does not modify any law applicable to the relationship between a person furnishing professional services and a person receiving such service, including liability for tort arising out of such professional service. . . . Subject to the foregoing provisions of this section, the members or shareholders of any professional association organized pursuant to the provisions of this act shall not be individually liable for the debts of, or claims against, the professional association unless such member or shareholder has personally participated in the transaction for which the debt or claim is made or out of which it arises.

See also Ala. Laws 1961, act 865, § 14: "The assets of a professional association shall not be liable to attachment for the individual debts of its members or shareholders." This latter provision should not be interpreted as negating liability of the association as the principal of its agents and employees. N.J. Stat. Ann. § 14:19-8 (1963). See note 253 *infra*. The Georgia (Ga. Code Ann. § 84-4307 (1961)) and South Carolina (S.C. Code § 56-1607 (1962)) acts are identical except that they preserve "liability arising out of such professional service" not merely the tort liability arising therefrom. The acts of Illinois (Ill. Ann. Stat. ch. 106½, § 106 (Smith-Hurd 1962)), Ohio (Ohio Rev. Code Ann. § 1785.04 (Supp. 1962)), and Oklahoma (Okla. Stat. Ann. tit. 18, § 812 (Supp. 1962)) also preserve the liability arising out of the professional relationship, but do not make any express provision for limiting liability. However, it may be inferred in Ohio and Oklahoma from the applicability of their business corporation laws. Ohio Rev. Code Ann. § 1785.08 (Anderson Supp. 1962), Ohio Rev. Code Ann. § 1701.32 (Page Supp. 1962); Okla. Stat. Ann. tit. 18, § 805 (Supp. 1962). See Note, 31 U. Cinc. L. Rev. 341, 344-45 (1962) noting that the Ohio constitution requires shareholders in a corporation to have limited liability, but that the Ohio "association" members while not subject to partnership liability do not enjoy limited liability. Vesely, *supra* note 214, at 203 suggests that the preservation of professional liability applies only to the members as employees not as shareholders, so that limited liability is provided. See Comment, 16 Sw. L.J. 462, 487 n.91 (1962).

The Tennessee statute (Tenn. Code Ann. § 61-105(3c) (1962)) simply provides that "The members of the association shall not be personally liable for debts of, or claims against the association." While this enacts limited liability it may nevertheless be modified by the provision (Tenn. Code Ann. § 61-105(3c) (1962)) making the association "subject to the laws . . . regulating the practice of the profession." If this latter provision is construed to include ethics as well as laws regulating the professions, the Tennessee statute would not be unlike those state statutes expressly preserving the liability arising out of the professional relationship. See Comment, 29 Tenn. L. Rev. 437, 446 (1962). See also notes 249, 250, 258, 259 *infra*.

<sup>249</sup> Professor Bittker contends that a member's liability is retained to the same extent as if he were still a partner, in particular, he is liable for his breaches of contracts as well as for his torts, and for the torts or misconduct of the other association members and of persons working under his supervision. This construction is strengthened by the clause appearing in some state statutes like that of Alabama which denies limited liability to a member who has personally participated in the transaction giving rise to the debt or claim. Bittker, *supra* note 221, at 8-13. See Comments, 12 Mercer L. Rev. 388, 397 (1961); 16 Sw. L.J. 462, 486-87 (1962). It seems, however, that state courts will more likely construe

which apparently have only relieved the members of personal liability for contractual debts of the organization have probably preserved the ethical responsibilities of the lawyers involved but have not met the requirements of the regulations in that freedom from personal liability for "claims against the organization" would seem to include freedom from tort as well as contractual claims.<sup>250</sup>

The question still remains of what is the minimum liability that must be preserved in order to satisfy ethical standards. Since these professional organizations are joint enterprises, it may be argued that nothing short of partnership-type liability preserves the existing professional relationship. This seems to be the theory of a 1950 opinion of the ABA Committee on Professional Ethics,<sup>251</sup> but the recent Opinion 303 makes no mention of such a requirement and observes that lawyers may practice under a form of organization that imposes limited liability as long as the lawyer or lawyers rendering the services are personally responsible to the client, and the restrictions on the liability of the other lawyers in the organization are made apparent to the client.<sup>252</sup> The latter requirement can be met by an identifying designation such as "Professional Association," "P.A.," "Professional Service Corporation," or "Chartered" which should no longer be condemned as trade names.<sup>253</sup> The former requirement raises questions under Canon 34 which prohibits a division of fees for legal services, except with another lawyer, based on a division of service or responsibility. Since the income of the professional association or corporation will be derived from the services of its lawyer employees, the salaries of such employees and any distributions to the owners must be based upon a contribution of services or a sharing of

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the preservation of the professional relationship as retaining the liability of a member for torts committed by him (and possibly by those under his direct supervision) and for breaches of his contractual or fiduciary obligations arising out of transactions in which he participated in his professional, as distinct from administrative, capacity. The mutual liability of partners is a matter of partnership law and does not inhere in the professional relationship, and thus would not apply to the members of a professional corporation or association unless the statute creating the entity provided for it. See Grayck, *supra* note 225, at 474-78; Note, 75 Harv. L. Rev. 776, 781 (1962); notes 237, 241, 242, *infra*. See also Harvard Student Legislative Research Bureau, *supra* note 211, at 417-18 suggesting alternative provisions, one retaining partnership liability and another limiting personal liability to the person rendering the service and other shareholders participating therein. The authors express the hope that the latter provision will satisfy the Kintner regulations.

<sup>250</sup> See Conn. Gen. Stat. Ann. § 34-82(1c) (1960); Ky. Rev. Stat. § 274.055 (1962); Wis. Stat. Ann. § 180.99(8) (Supp. 1963); cf., Arizona statutes, *supra* note 246. See Bittker, *supra* note 236, at 23; Kahn, *supra* note 212, at 77. But see Note, 31 U. Cinc. L. Rev. 71, 76, 82 (1962) making the questionable suggestion that an Ohio association could qualify under the regulations with personal liability limited only as to contractual obligations.

<sup>251</sup> Opinion 283 (1950) holding practice in the form of a Massachusetts Trust improper because, among other reasons, the trustees would not be liable for the acts of the beneficiaries and the beneficiaries would not be personally liable for the acts of the trustees.

<sup>252</sup> ABA Comm. on Professional Ethics, Opinion 303 (1961). See 31 U. Cinc. L. Rev. 341, 345 (1962).

<sup>253</sup> See notes 227-30 *supra* and accompanying text.

responsibility.<sup>254</sup> In a partnership, if a partner did not contribute his services to a particular client on a particular matter, he could nevertheless share in the fee because his personal liability as a partner placed him under responsibility to all the clients of the partnership. Even with this legal liability removed, the members of an association will still bear a professional responsibility for the legal services of the organization. Responsibility can be moral as well as legal, and can include supervision or control of the lawyer rendering the services.<sup>255</sup> Thus, the managers and officers of a professional organization, and perhaps all the members, may share in the responsibility to the clients of the organization. Furthermore, since the income from all sources is pooled, and total expenses deducted, it may be impossible to determine whose salary represents what legal fees.<sup>256</sup> As long as all the shareholders are also active employees, it would seem that the Canons of Ethics do not require that they be personally liable to the same extent as members of a partnership.<sup>257</sup>

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<sup>254</sup> The question has been raised as to whether Canon 34 will be violated by a distribution of earnings from a profit-sharing or pension plan at a time when the distribution is not in proportion to the services being rendered. (It is not anticipated that there will be any other distribution of earnings.) See ABA Special Comm. to Cooperate with the ABA Comm. on Professional Ethics Re Ass'ns of Attorneys Taxable as Corporations, ABA Section of Taxation Bull. 41, 52-53 (Oct. 1961); Waisel, "Attorneys' Federal Income Taxes," 66 Dick. L. Rev. 75, 81-82 n.52 (1961). However, it would seem that the allocation of services and responsibility to earnings should be made (if indeed it ever can be accurately made) at the time of contributions to such plans and not at the time of distribution. See note 256 *infra*. The earnings of the accumulated funds are interest on an investment which any attorney is free to make and which several states give the association or corporation express authority to make. See note 183 *supra*; Alabama Bar Ass'n, *supra* note 238, at 86. See also Carrington & Sutherland, *supra* note 217, at 75-76 suggesting that law partnerships reduce taxes by paying younger partners more at a time when they are in a lower tax bracket, with the expectation that the older men, who presently cut their income, will be paid more in their less productive or retirement years. See note 258 *infra*, regarding payments to the estate of a deceased member.

<sup>255</sup> ABA Comm. on Professional Ethics, Opinions 303 (1961), 204 (1940).

<sup>256</sup> See N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinion 684 (1946) holding that where a partnership with an out of state attorney is legal, it is not improper to pool the income, deduct the expenses, and then divide the net profit among the partners. See also Note, 75 Harv. L. Rev. 776, 789 (1962) suggesting that since it may be too difficult, especially for a client, to determine who has contributed services to a client's project or who was negligent in his contribution, it may be better to hold the entire firm liable especially where the client looks to the organization as a whole to serve his legal needs. This result would, of course, eliminate the fee-splitting problem. Partnership income is not always based upon services being rendered at the time the income is received. See Carrington & Sutherland, *supra* note 219; American Bar Foundation Research Memo No. 28, *supra* note 238, at 16. See also New Jersey (N.J. Stat. Ann. § 14:19-7 (1963)), permitting the corporation to charge and collect fees and compensate the officers, employees and agents.

<sup>257</sup> See N.Y. Co. Lawyer's Ass'n, Comm. on Professional Ethics, Op. 170 (1919) stating that a partnership should not continue with a dormant partner who shares in the fees but contributes no services and only bears formal responsibility and lends the use of his name. Such an arrangement begets increased commercialism and decreased professional responsibility. However, a temporary absence or one due to ill health or old age was not considered cause to terminate the partnership arrangement. Va. Code Ann. § 54-885 (Supp. 1962) requires its associates to be employees of their association, and Colorado (Colo. R. Civ. Proc., Rule 265 § I(D) (Supp. 1961)) requires the shareholders in its corporations to be actively engaged in the practice of law for their corporation except during periods of illness, accident, armed service, vacations, and leaves of absence not to exceed one year. The ABA Special Comm., *supra* note 254, at 52-53 notes that unless supplying capital is itself a responsibility



This result is consistent with the opinion of the Supreme Court of Florida approving that state's provision that a shareholder shall remain personally liable for any negligent or wrongful acts or misconduct committed by him, or by any person under his direct supervision and control, while rendering professional services on behalf of the corporation.<sup>258</sup> However, a provision like the Florida one may not meet the Kintner regulations' requirement of limited liability since it probably makes the supervising attorney liable for more than his own negligence.<sup>259</sup>

The Colorado Rule uniquely provides that the shareholders of its professional corporations will be jointly and severally liable for the acts and omissions of the employees of the corporation unless adequate liability insurance is provided.<sup>260</sup> The effect of this provision could be questionable in light of a statement in the regulations that if a member remains personally liable under local law notwithstanding an indemnification agreement, limited liability will not be attained.<sup>261</sup> But considering the recognized tax purpose of the professional corporation, it is likely that the Colorado Court will construe their own rule as completely relieving the shareholders of personal liability during periods when the required liability insurance is carried. Court rules of this nature are desirable since they assure ethical acceptance and favorable construction while also encouraging malpractice insurance to protect an attorney's clients.

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(an unlikely conclusion), the ownership must be restricted to employees of the organization. See also *Bye & Young*, supra note 217, at 436; Comment, 16 Sw. L.J. 462, 489 (1962); Note, 31 U. Cinc. L. Rev. 341, 346-47. But see Note, 35 Temp. L.Q. 312, 317-18 (1962). It has also been suggested that the joint and several liability of law partners is a matter of partnership law and not legal ethics. Alabama Bar Ass'n, supra note 238, at 84. Except as modified by Canon 34 this proposition is probably valid.

<sup>258</sup> Matter of The Florida Bar, 133 So. 2d 554, 556 (Fla. 1961) noting that the Florida act makes an additional remedy available against the corporation to the extent of its assets. Fla. Stat. Ann. § 621.07 (Supp. 1962). This remedy (which should be available through the doctrine of respondeat superior even in the absence of a statutory provision) may provide an extent of protection to the client beyond the individual practitioner's liability but falling short of partnership liability. See *United States v. Kintner*, 216 F.2d 418, 424 (9th Cir. 1954). The provisions of the Michigan (Mich. Stat. Ann. § 21.315(6) (1962)), New Jersey (N.J. Stat. Ann. § 14:19-8 (1963)), and Virginia (Va. Code Ann. §§ 54-886, -892 (Supp. 1962)) are similar to the Florida ones but the Virginia statute expressly disclaims partnership liability stating that an associate shall not be liable for any debts or claims against the association or another associate or employee other than one under his direct supervision and control. See also Alabama Bar Ass'n, supra note 238, at 84 concluding that the Alabama act meets ethical standards.

<sup>259</sup> It has been asserted that the regulations do not permit any vicarious liability on the part of a member. Comment, 16 Sw. L.J. 462, 486-87 (1962). If so, and the proposition is not free from doubt, then the Florida provision will not meet the regulations unless it can be said that the supervising shareholder will be negligent in his supervision or selection of underlings in every instance in which the underling commits a negligent or wrongful act. Compare Bittker, supra note 236, at 10 with Grayck, supra note 225, at 477-78.

<sup>260</sup> Colo. R. Civ. Proc., Rule 265 § I(G) (Supp. 1961). See Note, 75 Harv. L. Rev. 776, 789 (1962). The required amounts of liability insurance will exceed the asset value of the average partnership. *Bye & Young*, "Law Firm Incorporation in Colorado," 34 Rocky Mt. L. Rev. 427, 437 (1962).

<sup>261</sup> Treas. Reg. § 301.7701-2(d) (1960)

Although many of the states do not achieve limited liability under the regulations, the provisions may still be entitled to some weight in determining how closely a professional organization resembles a business corporation.<sup>262</sup> Furthermore, since an association is required to have only three out of four of the principal corporate characteristics, and since there is no need to encourage investment in a professional corporation, it may be desirable from a public relations standpoint for an organization of lawyers to retain full personal liability.<sup>263</sup>

5. *Free Transferability of Interests.*<sup>264</sup> This is the power of each member, without the consent of the other members, to substitute another person for himself as a member of the organization, thereby transferring all the attributes of membership—not merely a right to share in profits without participating in management. This characteristic will not be present if the transfer, under local law, results in a dissolution of the old organization and the formation of a new one (as is likely the case with a partnership).<sup>265</sup> For the transfer to be completely free it must be capable of being made without the consent of the other members, but a modified form of free transferability exists when a member is required to offer his interest to the other members at its fair market value before he may transfer it to a non-member. The modified form of free transferability is acceptable under the regulations but will be given less significance in determining the classification of the organization for tax purposes.

For the same reasons that only lawyers may form a professional organization to practice law, transfers of membership or ownership must like-

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<sup>262</sup> See notes 284, 285 *infra* and accompanying text.

<sup>263</sup> Treas. Reg. §§ 301.7701-2(a), (g)(1), (g)(5) (1960). See Note, 75 Harv. L. Rev. 776, 789-90 (1962); Comment, 16 Sw. L.J. 462, 499-500 (1962). The American Institute of Certified Public Accountants has not approved the practice of accountancy in association or corporation form because among other reasons, of the unfavorable impression that might be created by people thinking liability is being limited and that the accountants are taking advantage of a tax "gimmick." Compare the attitude of the Supreme Court of Florida in approving that state's act for use by attorneys. In re The Florida Bar Association, *supra* note 258. See notes 319, 344 *infra* and accompanying text. See also note 153 *supra*.

<sup>264</sup> Treas. Reg. § 301.7701-2(e) (1960). See Ray, *supra* note 215, at 81. The regulations have been criticized as requiring more freedom of transfer than many business corporations presently provide for. See Maier & Wild, *supra* note 217, at 139-40; Note, 12 Stan. L. Rev. 746, 758 (1960); Cf. Smith, "Associations Classified as Corporations Under the Internal Revenue Code," 34 Cal. L. Rev. 461, 522-25 (1946). Restrictions on the alienability of a business corporation's stock are generally held to be valid as long as transferability is not totally prohibited. 12 Fletcher, *Cyclopedia Private Corporations* §§ 5452-5458 (1957); Stevens, *Private Corporations* § 129 (2d ed. 1949). Restrictions are especially common in close corporations. 2 O'Neal, *Close Corporations* ch. 7 (1958); Harvard Student Legislative Research Bureau, "Incorporation of Professional Groups: A Model Act," 47 Mass. L.Q. 405, 415-16 (1962).

<sup>265</sup> See Crane, *Partnership* 415-16 (2d ed. 1962). The Uniform Partnership Act provides that an assignment of a partner's interest merely transfers a right to share in profits not management, and while the assignment does not automatically dissolve the partnership, it gives the remaining partners the option to do so without violating their agreement. §§ 27, 31(1)(c). See Comment, 16 Sw. L.J. 462, 488 (1962).

wise be limited to lawyers. To permit a non-lawyer to become a member of such an organization would involve violations of Canon 33 (forbidding partnerships with non-lawyers), Canon 34 (fee splitting with non-lawyers), Canon 35 (lay intermediary controlling or exploiting legal services), Canon 47 (aiding the unauthorized practice of law), and would probably also violate Canon 31 (lay interference in professional decisions) and Canon 37 (interference with confidential relationship).<sup>266</sup> Consequently, all of the states restrict transfers of membership or ownership to qualified professional persons.<sup>267</sup> Such a restriction does not, according to an example furnished with the regulations, negate the attribute of free transferability.<sup>268</sup>

Ethical problems may nevertheless arise when a member dies, becomes insolvent, incompetent, disqualified or wishes to resign and cannot find a qualified person to purchase his interest. Such a member or his personal representative should possess the authority to make a transfer to a

<sup>266</sup> ABA Comm. on Professional Ethics, Opinion 303 (1961); Note, 37 *Notre Dame Law.* 545, 547 (1962).

<sup>267</sup> E.g., Ala. Laws 1961, act 865, § 9: "A professional association may issue its capital if it is a stock-type association or accept as members of the professional association, if a non-stock association, only persons who are duly licensed or otherwise legally authorized to render the same professional service as that for which the professional association was organized." Colo. R. Civ. Proc., Rule 265 § I(D) (Supp. 1961): "All shareholders of the corporation shall be persons duly licensed by the Supreme Court of the State of Colorado to practice law in the state of Colorado, and who at all times own their shares in their own right." Okla. Stat. Ann. tit. 18, § 809 (Supp. 1962):

A professional corporation may issue the shares of its capital stock only to persons who are duly licensed to render the same specific professional services as those for which the corporation was organized. A shareholder may voluntarily transfer his shares in a professional corporation only to a person who is duly licensed to render the same specific professional services as those for which the corporation was organized. Any shares issued in violation of this section are null and void. The voluntary transfer of any shares transferred in violation of this section is null and void. No shares may be transferred upon the books of the professional corporation or issued by the professional corporation until there is presented to and filed with the corporation a certificate by the regulating board stating that the person to whom the transfer is to be made or the shares issued is duly licensed to render the same specific professional services as those for which the corporation was organized.

Va. Code Ann. § 54-888 (Supp. 1962):

Except to the extent provided in the articles of association or the by-laws, certificates of ownership shall be freely transferable by any associate to another associate, or to other associates, or to any person who is not an associate provided such person is duly licensed or qualified under the laws of this State to render the same kind of professional service which the association was organized to render, and such transferee shall thereupon become an associate in the organization and be entitled to participate in its management and affairs with all the rights of the transferor of such interest.

See note 158 *supra*.

<sup>268</sup> Treas. Reg. § 301.7701-2(g)(1) (1960). See ABA Special Comm., *supra* note 254, at 52 observing that the regulations only require transferability to "a person" not to "any person," thus limiting transfers to lawyers comes within the literal requirement. But see Bittker, *supra* note 221, at 17-20, 21 n.38. Grayck, *supra* note 238, at 483 notes that Bittker bases his conclusion on policy not the requirements of the regulations. It is less certain, however, that transfers restricted to qualified professionals who will be active employees of the organization (as is probably necessary, see note 259 *supra*) will still be free enough under the regulations. See Comment, 16 *Sw. L.J.* 462, 489 (1962); Note, 31 *U. Cinc. L. Rev.* 341, 347 n.33 (1962).

qualified person,<sup>269</sup> and in the event no such transfer is consummated within a reasonable time, the organization should be required to purchase the interest.<sup>270</sup> The recent ABA Opinion 303 stated that the temporary holding of the interest by a non-lawyer personal representative does not violate the Canons of Ethics as long as the layman has no say in management and does not have access to the confidences of any client.<sup>271</sup> While the ABA opinion places a great emphasis on a temporary versus a permanent holding of an interest,<sup>272</sup> it would seem that *all true ownership* by a layman is forbidden. Thus, an executor, administrator or other representative of a former member may "own" the interest in name only, and must not be permitted to exercise any of the attributes of ownership except the right to transfer. Accordingly, neither the personal representative nor the heirs of a deceased member may share in the income of the organization which is earned after the death of the member. This does not, however, prevent such persons from receiving future payments based upon the member's prior services for which compensation had not yet been received.<sup>273</sup>

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<sup>269</sup> See e.g., Ariz. Rev. Stat. Ann. § 10-909(D) (Supp. 1962); Pa. Code Ann. tit. 184, §§ 197-12, -18 (Supp. 1962). See also note 224 supra.

<sup>270</sup> See e.g., Ariz. Rev. Stat. Ann. § 10-909(D) (Supp. 1962); Colo. R. Civ. Proc., Rule 265 § I(E) (Supp. 1961); Ky. Rev. Stat. § 274.095 (1962); N.J. Stat. Ann. §§ 14:19-10, -13c (1963); Okla. Stat. Ann. tit. 18, § 815 (Supp. 1962). See Harvard Student Legislative Research Bureau, supra note 264, at 414-16. It has been contended that a requirement of this nature will prevent the free transferability of the shares. Note, 37 Notre Dame Law. 545, 548 (1962). But the provisions for redemption will operate only if no valid transfer has been made, and a transfer to a member of the association or corporation is consistent with the concept of free transferability as practiced in business corporations. See notes 264, 268 supra, 282, 286 infra. Restrictions on a corporation purchasing its own stock should not apply to these professional organizations. See note 222 supra.

<sup>271</sup> See note 266 supra. See also Alabama Bar Ass'n, supra note 238, at 85; notes 237, 238 supra. The provisions cited in notes 222, 270 supra, generally contain restrictions to the effect that the personal representative shall not be permitted to vote the interests being held or otherwise participate in the management of the organization or rendering of professional services. See Harvard Student Legislative Research Bureau, supra note 264, at 411-12.

<sup>272</sup> See note 265 supra. The opinion states at least eight times that it would be unethical to transfer "permanent beneficial and voting interests" to a layman. The late Dean Sturges used to comment that many judges seem to think that if they state a proposition three times within the course of an opinion, it becomes the law. Perhaps this was the theory of the ABA ethics committee, but it is submitted that a layman cannot hold even a temporary voting interest in a professional association engaged in the practice of law. However, the ABA's ultimate conclusion that a personal representative may hold a nonparticipating interest for a limited time and purpose seems sound.

<sup>273</sup> The widow or other beneficiaries of a deceased lawyer are entitled to the lawyer's share in his former practice as of the date of his death. This may include his interest in the library, furniture, unexpired lease and future fees accruing from services performed prior to his death, but nothing may be paid for any goodwill which the deceased may have acquired or contributed to his firm. ABA Comm. on Professional Ethics, Opinion 266 (1945), Informal Decision Nos. 507, 628 (1962) (may pay a disbarred attorney a share of a contingent fee for services rendered in a matter unrelated to his disbarment and prior thereto); N.Y. Co. Lawyer's Ass'n Comm. on Professional Ethics, Opinions 352 (1939), 161 (1918); N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinion 771 (1952), 755 (1950), 706 (1947), 618 (1942), 100 (1928-29). See note 279 infra. However, the former associate may make an additional gift to the widow as long as they do not enter into

Similar considerations prohibit a lawyer from selling his interest in the organization's future earnings or good will.<sup>274</sup> It is sometimes said that a lawyer cannot acquire any good will because his success depends upon his personal ability and efforts, and his personal reputation cannot be assigned to others.<sup>275</sup> It is true that an attorney has no property interests in his clients; they are free at any time to choose another attorney.<sup>276</sup> Nevertheless some clients are inclined to continue to consult the same firm, especially when it operates under the same name, even though old members leave and new ones are added. The value of this probability of recurring clientele is properly labeled as the good will of the firm.<sup>277</sup> Moreover, it seems apparent that the privilege of becoming

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a fee sharing contract. N.Y. Co. Comm., *supra*, Opinion 161 (1918); N.Y. City Comm., *supra*, Opinion 591 (1941). And in order to avoid difficult questions of accounting, the articles of partnership could provide for a percentage of earnings to be paid to the estate of a deceased partner for a limited number of years in lieu of his share of fees earned but not billed at the time of his death. The payment must be a reasonable approximation of the fees due the deceased. N.Y. City Comm., *supra*, Opinion 706 (1947). While another lawyer may not solicit a deceased lawyer's clients, it is proper for an associate to contact the clients and inform them of the death and state that any pending matters will be handled by the associate unless and until the client names another counsel. ABA Comm., *supra*, Opinion 266 (1945), Informal Decision No. 507 (1962); N.Y. City Comm., *supra*, Opinion 618 (1942); Alabama Bar Ass'n, *supra* note 238, at 82. But see N.Y. City Comm., *supra*, Opinion 329 (1935) where the Committee stated that an associate of a deceased lawyer may make payments to the widow "for the files and tangible assets; and the general good will." Apparently many law partnerships now provide for payments to a deceased partner's estate as a gratuity or in lieu of good will. See Carrington & Sutherland, *Articles of Partnership for Law Firms*, ABA Economics of the Law Practice Series, Pamphlet No. 6, 51-54, 67 (1961).

<sup>274</sup> ABA Comm. on Professional Ethics, Opinion 266 (1945); N.Y. Co. Lawyer's Ass'n Comm. on Professional Ethics, Opinion 352 (1939); N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinions 646 (1943), 633 (1943), 588 (1941), 272 (1933). A transferring lawyer, like the estate of a deceased lawyer, can continue to share in fees from his prior services. N.Y. City Bar Ass'n, *supra*, Opinions 679 (1945), 100 (1928-29). See also note 258 *supra*.

<sup>275</sup> See e.g., *Siddall v. Keating*, 8 App. Div. 2d 44, 185 N.Y.S.2d 630 (1st Dep't 1959); *Arundell v. Bell*, 52 L.J. Ch. 537, 19 Eng. Rul. Cas. 657 (1883); ABA Comm. on Professional Ethics, Opinion 6 (1925); N.Y. City Bar Ass'n, Comm. on Professional Ethics, Opinion 679 (1945); cf. *Masters v. Brooks*, 132 App. Div. 874, 878-80, 117 N.Y. Supp. 585, 588-90 (1st Dep't 1909).

<sup>276</sup> See *Trenbath v. Platt*, 20 N.Y.S.2d 244, 249 (Sup. Ct. N.Y. County 1940), *aff'd* 264 App. Div. 708, 34 N.Y.S.2d 526 (1st Dep't), appeal denied, 288 N.Y. 741, 42 N.E.2d 751 (1942); ABA Comm. on Professional Ethics, Opinions 266 (1945), 10 (1926); N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinions 633 (1943), 618 (1942); 588 (1941); *Drinker*, *Legal Ethics* 94, 198-200 (1953). The ABA Committee has recently held that it would not be proper for a law firm and a lawyer-employee to agree to a restrictive covenant in an employment contract. Opinion 300 (1961), 47 A.B.A.J. 977 (1961); Informal Decision No. 521 (1962). But see the following cases which enforced reasonable covenants not to compete entered into by attorneys: *Smalley v. Greene*, 52 Iowa 241, 3 N.W. 78 (1879); *Bunn v. Guy*, 4 East 190, 102 Eng. Rep. 803 (K.B. 1803). Some partnership agreements now contain covenants not to compete and they are not considered unethical. See Carrington & Sutherland, *supra* note 273, at 59-60; ABA Comm., *supra*, Informal Decision No. 521 (1962).

<sup>277</sup> Good will was long ago described, by Lord Chancellor Eldon, as "the probability that the old customers will resort to the old place." *Crutwell v. Lye*, 17 Ves. Jun. 335, 346, 34 Eng. Rep. 129, 134 (Ch. 1810). Cardozo stated that the chief elements of value upon the sale of good will are continuity of place and continuity of name, and in a complex business, continuity of organization. *Matter of Brown*, 242 N.Y. 1, 5, 150 N.E. 581, 583 (1926). A professional organization enjoying continuity of life and of name will

a member of a successful law firm and sharing in the income therefrom is worth more than an interest in an unsuccessful or unknown law firm, and this difference in value is a difference in good will. Notwithstanding the existence of good will as an economic fact,<sup>278</sup> permitting an attorney to sell his interest in good will would allow him to share in fees from legal services without a division of services or responsibility, would allow the buyer to purchase clients, frequently would obligate the seller to solicit his former clients to employ his successor, and, if the seller's files were relinquished to the buyer, might result in revealing the confidences of clients without their consent.<sup>279</sup> Whether the ABA Committee in its

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have a greater opportunity to acquire good will. The ABA Committee on Professional Ethics has stated that "the continued use of a firm name by one or more surviving partners after the death of a member of the firm whose name is in the firm title is expressly permitted by the Canons of Ethics. The reason for this is that all of the partners by their joint and several efforts over a period of years contributed to the good will attached to the firm name." Opinion 267 (1945). This opinion was rendered the same day as Opinion 266 (1945) stating: "The good will of the practice of a lawyer is not, however, of itself an asset, which either he or his estate can sell." See also note 278 *infra*.

<sup>278</sup> It is recognized by many law firms that good will can become a significant asset, but upon withdrawal of a partner his interest in the good will is usually forfeited to the remaining partners. Indeed the protection of this interest has been urged as a reason for permitting surviving partners to continue to use the name of their former partner. ABA Comm. on Professional Ethics, Opinion 267 (1945), set forth at *supra* note 277. Occasionally, firms will provide for payments of a fee to former partners or their estates for the use of the former partner's name or a gratuity in recognition of his services. See Carrington & Sutherland, *supra* note 273, at 33, 51-62, 67-68. See notes 258, 262 *supra*; *cf.*, ABA Comm., *supra*, Opinion 6 (1925). Several cases, especially older ones, have recognized that professionals may acquire good will and that it may be transferred, or that at least a consideration may be paid for a covenant not to compete and an agreement by the transferor to recommend his clients to the transferee. Lawyers and solicitors: *Smalley v. Greene*, 52 Iowa 241, 3 N.W. 78 (1879); *Austen v. Boys*, 2 De G. & J. 626, 44 Eng. Rep. 1133 (1858); *Bunn v. Guy*, 4 East 190, 102 Eng. Rep. 803 (Ch. 1803). *Contra*, *Siddall v. Keating*, 8 App. Div. 2d 44, 185 N.Y.S.2d 630 (1st Dep't 1959); *Arundell v. Bell*, 52 L.J. Ch. 537, 19 Eng. Rul. Cas. 657 (1883). Physicians: *Hoyt v. Holly*, 39 Conn. 326, 12 Am. Rep. 390 (1872); *Harshbarger v. Eby*, 28 Idaho 753, 156 Pac. 619 (1916); *Tichenor v. Newman*, 186 Ill. 275, 57 N.E. 826 (1900); *French v. Parker*, 16 R.I. 219, 14 Atl. 870 (1888); *Randolph v. Graham*, 254 S.W. 402 (Tex. Civ. App. 1923). Dentists: *H. M. LaRue*, 37 T. C. 39 (1961); *Cook v. Johnson*, 47 Conn. 175, 36 Am. Rep. 64 (1879); *Slack v. Suddoth*, 102 Tenn. 375, 52 S.W. 180 (1899). Accountants: *Evans v. Gunnip*, 135 A.2d 128, 65 A.L.R.2d 513 (Del. 1957). *Contra*, *Cook v. Lauten*, 1 Ill. App. 2d 255, 117 N.E.2d 414 (1954); *cf.* *Lynch v. Bailey*, 275 App. Div. 527, 90 N.Y.S.2d 359 (1st Dep't 1949). It has been suggested that a professional person's good will may not be assigned but a transferee's chances of success may be enhanced by the transferor withdrawing as a competitor. *Cowan v. Fairbrother*, 118 N.C. 406, 24 S.E. 212 (1896). See *Bye & Young*, *supra* note 260, at 450 suggesting that good will exists to the extent the value as an organization exceeds the value of each member practicing separately. See also notes 82-85, 122 *supra* and accompanying text. The following "general rules" are stated in American Jurisprudence:

The good will that an attorney at law has built up in the practice of his profession may be made the subject of sale, like that of any other business. [Citing to section on Good Will.]

5 Am. Jur. Attorneys at Law § 9 (1936).

Frequently, it has been said that salable good will can exist only in commercial or trade enterprises and that it cannot arise in a professional business depending upon the personal skill and confidence in a particular person. . . The better doctrine, however, appears to be that good will also exists in a professional practice or in a business which is founded upon personal skill or reputation. [Citing cases, none of which involves lawyers.]

24 Am. Jur. Good Will § 11 (1939).

<sup>279</sup> Canons 27, 28, 34, & 37; ABA Comm. on Professional Ethics, Opinion 266 (1945),

Opinion 303 failed to discuss this matter because of an unexplained oversight of the ethical problems or an unexpressed insight into reality, it still seems that a transfer of an interest in an organization engaged in the practice of law should be restricted to the extent that the consideration paid for it may not include an allowance for good will.<sup>280</sup> Contrary to the opinion of some writers,<sup>281</sup> such a restriction should not destroy the free transferability of the interest. The regulations do not require that an interest always be transferred at its fair market value,<sup>282</sup> and

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Informal Decision No. 507 (1962); See N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinions 771 (1952), 735 (1949), 633 (1943); see also note 259 *supra*.

<sup>280</sup> See ABA Comm. on Professional Ethics, Informal Decision No. 507 (1962) rendered after Opinion 303 (1961) and reaffirming the principles of Opinion 266 (1945), notes 274, 279 *supra*. Studies on this matter were apparently available to the ABA Committee at the time it rendered Opinion 303. See American Bar Foundation, *supra* note 238, at 22-23 and authorities cited therein. See also Drinker, *Legal Ethics* 189 (1953); Alabama Bar Ass'n, *supra* note 238, at 85-86; N.Y. City Bar Ass'n Comm. on Professional Ethics, Opinion 633 (1943):

Clients are not merchandise. Lawyers are not tradesmen. They have nothing to sell but personal service. An attempt, therefore, to barter in clients would appear to be inconsistent with the best concepts of our professional status. This notwithstanding the absence of any reference to the subject in the Canons. This does not prohibit any attorney from advancing to the partnership the necessary funds to enable it to pay out the agreed value of the retiring partner's interest without allowance for good will or firm name, and thereupon becoming a member of the new firm.

But see, N.Y. City Comm., *supra*, Opinion 329 (1935).

It may be that the sale of an interest in a professional association can be distinguished from a sale of an individual's practice. The confidential relationship required by Canon 37 could be preserved, and the solicitation objection, while applicable in theory, would appear to be unrealistic since the existing members would no doubt veto undeserving potential members seeking to buy clients, and without any solicitation the clients would probably continue to consult the organization regardless of membership changes (unless they were lured away by the withdrawing member). The fee-splitting objection, however, is harder to overcome unless Canon 34 is amended or reinterpreted. There is no sharing of responsibility by the withdrawing attorney since the selection of a new attorney is not considered a sufficient responsibility under Canon 34. ABA Comm., *supra*, Opinions 204 (1940), 153 (1936). And even though the purchase price of the interest be paid in advance, it cannot be persuasively argued that the money does not come from legal services since the implication is clear that the buyer expects to recover his investment from future legal fees. See *O'Rear v. Commissioner*, 80 F.2d 473 (6th Cir. 1935) where the taxpayer, a former chief justice of the Kentucky Court of Appeals, sold interests in his law practice to two attorneys in order to form a three-man partnership with each holding an equal interest. The IRS and the court rejected his contention that he had conveyed good will, a capital asset, and held that the payments represented the present worth of the future legal fees which the taxpayer would have been entitled to because of his greater experience and reputation. But see notes 82-85, 122 *supra* and accompanying text. This is, incidentally, another example of the tax code's failure to recognize that the value of almost all "capital assets" is based upon their future earning capacity. See Kaldor, *An Expenditure Tax* 65 (1955); Miller, "The Capital Asset Concept," 59 *Yale L.J.* 837, 878, 885, 1078 (1950); Notes, 104 *U. Pa. L. Rev.* 1088, 1096 (1956), 35 *Texas L. Rev.* 861 (1957).

<sup>281</sup> E.g., Bittker, *supra* note 236, at 17-21 (1961); Vesely, "Ohio Professional Association Law," 13 *W. Res. L. Rev.* 195, 210 (1962). See also American Bar Foundation Memo, *supra* note 238, at 22-23; Note, 75 *Harv. L. Rev.* 776, 787 (1962).

<sup>282</sup> The only reference to this standard of pricing is in the section of the regulations permitting a modified form of free transferability to exist where the interest is first required to be offered to the other members at its "fair market value." *Treas. Reg.* § 301.7701-2(e)(2) (1960). This provision is apparently designed to deny the attribute of free transferability to those organizations which coerce a transferring member to sell his interest to the other members at an unfair price, far below that which an outsider would be willing to pay. See *Bye & Young*, *supra* note 260, at 443 n.106. Thus, as long as the same factors were taken into account in determining the price to members as to outsiders, it would seem

moreover, it may be contended that an interest's fair market value, unlike its black market value, includes only those factors which may lawfully be considered.<sup>283</sup>

In lieu of a payment for good will, a successful professional corporation or association will probably require a proposed transferee to have something exceptional by way of ability or reputation,<sup>284</sup> and it may develop that the most frequent source of new members in an association—as it is in a partnership—will be the deserving lawyer-employees of the organization. An appropriate measure of control over the admission of new members can be obtained by requiring that a withdrawing member first offer his interest to the other members or the organization before being permitted to transfer it to an outsider.<sup>285</sup> As already indicated, this modified form of free transferability is recognized by the Kintner regulations, and it is also permitted or required by almost all of the states.<sup>286</sup>

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that the purpose of the regulations would be satisfied. See notes 283, 285 *infra*. Book value and other standards of pricing which often do not include good will are used in stock purchase agreements of business corporations. See 2 O'Neal, *Close Corporations* § 7.24 (1958).

<sup>283</sup> The transferee of an interest in a law firm may pay for a share of the capital assets (library, furniture, fixtures, lease or building), accounts receivable and fees not yet paid but earned by the transferor. ABA Comm. on Professional Ethics, *Opinion* 266 (1945); N.Y. City Bar Ass'n Comm. on Professional Ethics, *Opinions* 755 (1950), 633 (1943), 329 (1935); see notes 273, 274, 278 *supra*; note 285 *infra*.

<sup>284</sup> This suggestion is merely a continuation of current practices. Two or more unestablished practitioners readily form partnerships, but an established attorney would ordinarily only form a partnership with another established attorney or one who possesses a great potential to attract clients or render extraordinary services. For an example of the ethical and other problems which may arise when these general practices are departed from, see *O'Rear v. Commissioner*, *supra* note 280.

<sup>285</sup> Such transfers must be made at the fair market value of the interest. See note 282 *supra*. It may be wise to provide for a method of determining fair market value in the enabling statute which will apply in the absence of another method provided for in the by-laws or articles of incorporation or association. See Kentucky (Ky. Rev. Stat. Ann. § 274.010(4) (1962)) requiring the corporation to apply to the court to determine the fair market value in the absence of another agreement. The "Model Act" provides alternative clauses, one setting book value as the standard, and the other, said to meet the Kintner regulations, providing for the appointment of three appraisers from the profession, one chosen by the corporation, one by the withdrawing member or his representative, and the third by the other two appraisers. Harvard Student Legislative Research Bureau, *supra* note 260, at 414-16; see *Bye & Young*, *supra* note 260, at 436. Several of the state statutes provide that in the absence of an agreement otherwise the price at which an association or corporation shall redeem the interests of a deceased, disqualified, or otherwise withdrawing member shall be the book value of such interest at the end of the month preceding the death or disqualification. E.g., Ala. Laws 1961, act 865, § 11; N.J. Stat. Ann. § 14:19-13 (1963); Okla. Stat. Ann. tit. 18, § 815 (Supp. 1962); Va. Code Ann. § 54-891 (Supp. 1962); Wis. Stat. Ann. § 180.99(10)(c) (Supp. 1962).

<sup>286</sup> See notes 264, 268, 282 *supra*. Tenn. Code Ann. § 61-105(3)(d) (Supp. 1962) requires a first offer to the other members. Conn. Gen. Stat. Ann. § 34-82(1)(d) (Supp. 1962) authorizes a first offer to the other members or the association. A few states risk the loss of this characteristic by requiring that a transfer be approved by at least a majority vote of the outstanding shares. Fla. Stat. Ann. § 621-11 (Supp. 1962); Mich. Stat. Ann. § 21.315(10) (Supp. 1963); N.J. Stat. Ann. § 14:19-10 (1963). See Harvard Student Legislative Research Bureau, *supra* note 260, at 414-15. Several of the other states expressly authorize restrictions to be made in the by-laws or articles on the transferability of the ownership interests. E.g., Ala. Laws 1961, act 865, § 9; Ariz. Rev. Stat. Ann. § 10-909 (D) (Supp. 1962); Pa. Stat. Ann. tit. 14, § 197-12 (Supp. 1962); Va. Code Ann. § 54-889 (Supp. 1962); see *Bye & Young*, *supra* note 260, at 443-44. First offer and other restrictions on



Another limitation which may be implied is that a membership should not be transferred (in the absence of appropriate safeguards) to an attorney who has clients whose interests may conflict with the interests of the organization's clients.<sup>287</sup> This limitation should not cause difficulty under the regulations since it is analogous to prohibited transfers of a business corporation's stock to competitors and others when anti-trust or other laws would be violated.<sup>288</sup>

Finally, it is required in a few states, and may be desirable in all states, to state on the face of the stock certificates or other evidences of ownership any restrictions which are placed on their transferability.<sup>289</sup>

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transferability are common with many business corporations, especially those closely held, and have not prevented such organizations and other noncorporate organizations from being taxed as corporations. See *Fidelity-Bankers Trust Co. v. Helvering*, 113 F.2d 14 (D.C. Cir.), cert. denied, 310 U.S. 649 (1940); 2 O'Neal, *supra* note 282, at §§ 7.05, 7.06, 7.08, 7.09; Stevens, *Corporations* § 129 (2d ed. 1949).

<sup>287</sup> Canon 6; ABA Comm. on Professional Ethics, *Opinions* 103 (1933), 72 (1932), 50 (1931), 49 (1931), 33 (1931); *Informal Decision No. C-437*; see *Opinion 181* (1938), overruled by *Opinion 271* (1946). The Committee on Professional Ethics of the Association of the Bar of the City of New York has held that a lawyer admitted in another state may be a member of a firm in such state and also have an office in New York (*Opinion 662* (1944)), and that an attorney may be a partner in two firms located in different boroughs as long as no conflicting interests will be represented and all parties consent (*Opinion 561* (1941)). See Kahn, *supra* note 250, at 74; 31 U. Cinc. L. Rev. 341, 346-47 (1962). Oklahoma (Okla. Stat. Ann. tit. 18, § 810 (Supp. 1962)) expressly prohibits a person from being an officer, director or shareholder of more than one professional corporation at the same time. Thus, not only can a lawyer not practice law with two corporations but if he is also qualified to practice accounting or any other profession, he cannot do both through a corporate form. See ABA Comm., *supra*, *Opinions* 305 (1962), 297 (1961) prohibiting an attorney-accountant from holding himself out to practice both professions.

Several states provide that if an owner or employee of the professional association or corporation accepts employment or public office which restricts the practice of his profession, he must sever his connection with the professional organization. See e.g., Ala. Laws 1961, act 865, § 10; Fla. Stat. Ann. § 621:10 (Supp. 1962); Wis. Stat. Ann. § 180.99(6) (Supp. 1962). See also Colo. R. Civ. Proc., Rule 265 § I(D) (Supp. 1961) requiring shareholders to be active employees of the corporation except while ill, injured, in armed services, on vacations, or on leaves of absence not to exceed one year. The ABA Comm., *supra*, has ruled that a member of a firm may remain a member while holding a full time government job if it is not illegal to do so, if the public is not misled, and if conflicting interests are not represented. *Opinion 192* (1939). See *United States v. Standard Oil Co.*, 136 F. Supp. 345 (S.D.N.Y. 1955); Canon 36.

<sup>288</sup> See 6A Fletcher, *supra* note 247, at §§ 2825-26, 2834-35, 2841; 10 Fletcher, *supra* note 247, at §§ 5004-05 (1961). But see Bittker, *supra* note 281, at 18.

<sup>289</sup> See Pa. Stat. Ann. tit. 14, § 197-12 (Supp. 1962); Va. Code Ann. § 54-889 (Supp. 1962). The Uniform Stock Transfer Act which applies to shares of a corporation (§ 22(1)) provides that a restriction cannot be effective unless it is stated upon the certificate (§ 15). See Buchmann & Bearden, "The Professional Service Corporation—A New Business Entity," 16 U. Miami L. Rev. 1, 11 (1961) stating that the Uniform Stock Transfer Act would apply to the professional corporation. It would not, however, apply to an association unless it was treated as a corporation under state law. The Uniform Commercial Code, Article 8, which has replaced the Stock Transfer Act in many states provides that a restriction must be noted conspicuously on the certificate to be effective against anyone but a person with actual knowledge of the restriction (§ 8-204). But that article applies only to securities which are defined as instruments "of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium of investment." (§ 8-102(1)(a)(ii)). It is unlikely that the interests in a professional association or corporation will be dealt in upon exchanges or otherwise publically traded or used as a medium of investment. However, comment 3 to § 8-204, indicates that the section is applicable to cooperative associations and private clubs. See also 12 Fletcher, *supra* note 247, at § 5458 (1957).

This may prevent unqualified persons from purchasing the interests and may help avoid the embarrassing situation of a person without notice of the restrictions obtaining an interest in violation of them.<sup>290</sup>

6. *Miscellaneous Corporate Characteristics.* The Kintner regulations provide that other characteristics of a corporation or a partnership may be given some significance in determining whether or not a particular organization qualifies as an association.<sup>291</sup> Consequently, a favorable ruling will be made more probable if the state law creates a legal entity, independent of the members, which has the power to contract, hold title to property, and can sue and be sued.<sup>292</sup> To further attain a corporate resemblance, the organization, among other things, could make articles of association and by-laws, provide for a board of directors or similar body, prepare a plan for managerial succession, hold directors' and owners' meetings, adopt formal voting procedures, maintain a formal record system, and enter into written employment contracts with its member employees.<sup>293</sup> If permitted by state law, the organization could also issue stock or other certificates of ownership and adopt a trade name and seal.<sup>294</sup>

Several of the association statutes have provisions expressly stating that the organization is to be an association and not a partnership or a corporation, or that it is to have characteristics like a corporation and not a partnership.<sup>295</sup> Since federal law determines the classification of an organization, these statements are not binding for tax purposes, but they may be helpful in interpreting the intent of the state to authorize the various corporate characteristics which will be considered in making

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<sup>290</sup> The "Model Act," Harvard Student Legislative Research Bureau, *supra* note 260, at 412-13 makes a transfer to an unqualified person and certain other prohibited actions ineffective, but protects an innocent person who is not a shareholder and who relied on the effectiveness of such action. See also Okla. Stat. Ann. tit. 18, § 809 (Supp. 1962), set forth at note 267 *supra*.

<sup>291</sup> Treas. Reg. § 301.7701-2(a)(1) (1960).

<sup>292</sup> See e.g., Ala. Laws 1961, act 865, § 14; Va. Code Ann. §§ 54-882, -894 (Supp. 1962). These powers should be implied under the corporation statutes. See 1 Fletcher, *supra* note 247, at §§ 5-14 (1931); Stevens, *supra* note 286, at § 3.

<sup>293</sup> The Virginia act (Va. Code Ann. §§ 54-882, -894 (Supp. 1962)) gives the most complete authorization for such matters, but organizations in the other states should be able to adopt the measures without express statutory authority. For examples of helpful factors, see Bye & Young, *supra* note 260, at 444-45 (noting that the larger the number of shareholders, the greater the probability that it will be taxed as a corporation); Edwards, "Taxation-Unincorporated Associations and the Medical Profession," 30 Miss. L.J. 293, 298 (1959); 6 Fletcher, *supra* note 247, at §§ 2474-2535 (1950).

<sup>294</sup> See e.g., Issue stock, Ala. Laws 1961, act 865, § 9; Fla. Stat. Ann. § 621.09 (Supp. 1962); Ohio Rev. Code Ann. § 1785.06 (Anderson Supp. 1962); Okla. Stat. Ann. tit. 18, § 809 (Supp. 1962); certificates of ownership, Pa. Stat. Ann. tit. 14, § 197-11 (Supp. 1962); Va. Code Ann. § 54-889 (Supp. 1962); seal, Va. Code Ann. § 54-881(c) (Supp. 1962); trade names, see notes 228-29 *supra*.

<sup>295</sup> E.g., Ala. Laws 1961, act 865, § 16; Ill. Ann. Stat. ch. 106½, § 101 (Smith-Hurd Supp. 1962); Tenn. Code Ann. § 61-105(2) (1962); Tex. Civ. Stat. Ann. art. 6132(6)(b)(3) (1962); Va. Code Ann. § 54-874(3) (Supp. 1962).

the ultimate tax classification. Another helpful provision contained in many of the states' acts makes the professional organization subject to their business corporation law where not in conflict with the authorizing grant.<sup>296</sup> Such provisions will endow the new entities with additional corporate attributes and will also avoid difficulties under state law by providing a guide to follow in this unchartered area.<sup>297</sup>

### C. *Tentative Conclusions*

On the basis of the foregoing analysis, it is quite conceivable that groups of lawyers organized under the various state statutes, as supplemented by carefully drawn articles and by-laws, could qualify as associations under the Kintner regulations without infringing ethical responsibilities. Since the regulations require that an association have more corporate than non-corporate characteristics, it would be sufficient if the organization, in addition to having associates and a joint-profit objective, possessed continuity of life, centralization of management, and a modified form of free transferability of interests.<sup>298</sup> In the event that the

<sup>296</sup> E.g., Ala. Laws 1961, act 865, § 16; Ariz. Rev. Stat. Ann. § 10-904 (Supp. 1962); Colo. R. Civ. Proc., Rule 265 § I(C) (Supp. 1961); Fla. Stat. Ann. §§ 621.5, .13 (Supp. 1962); Ky. Rev. Stat. § 274.015(2) (1962); Ohio Rev. Code Ann. § 1785.08 (Anderson Supp. 1962); Okla. Stat. Ann. tit. 18, § 805 (Supp. 1962); Tenn. Code Ann. § 61-105(3)(d) (Supp. 1962); Wis. Stat. Ann. § 180.99(3) (Supp. 1963). See note 220 *supra*.

<sup>297</sup> The new statutes have been criticized because they have plunged blindly into new areas of law in pursuit of tax advantages and in ignorance of state law consequences. Bittker, "Professional Associations and Federal Income Taxation: Some Questions and Comments," 17 *Tax L. Rev.* 1, 2, 28-30, 32-34 (1961); see note 316 *infra*; Note, 75 *Harv. L. Rev.* 776, 788 (1962). This criticism is more true of some statutes (e.g., Texas, see Bromberg, "Texas Uniform Partnership Act—The Enacted Version," 15 *Sw. L.J.* 386 (1961)) than others. Virginia has detailed provisions authorizing those corporate powers and attributes deemed applicable to the professional association. Va. Code Ann. §§ 54-882, -897, -898 (Supp. 1962). See also Mich. Stat. Ann. §§ 21.315(12) to (15) (1962); N.J. Stat. Ann. §§ 14:19-6, -13 to -17 (Supp. 1963). Other states provide that the organization shall have the powers, authority, duties and liabilities of corporations except as modified by the granting statute. E.g., Colo. R. Civ. Proc., Rule 265 § I(C) (Supp. 1961); Ky. Rev. Stat. § 274.015(2) (1962); Okla. Stat. Ann. tit. 18, § 805 (Supp. 1962); Wis. Stat. Ann. § 180.99(3) (Supp. 1963). A few of the problem areas are specifically covered by some statutes, e.g., mergers and consolidations are permitted only with domestic corporations rendering the same professional services. Fla. Stat. Ann. § 621.13 (Supp. 1962); Ky. Rev. Stat. § 274.085 (1962). In general, problems should be avoided by following the pattern of the business corporation acts where applicable. See note 296 *supra*; Buchmann & Bearden, *supra* note 289; Kahn, *supra* note 250. The new entities will likely be quite similar to close corporations in their operations, and can also be guided, where appropriate, by provisions now used in articles of partnership of law firms. See 1 O'Neal, *supra* note 282, at §§ 1.02, 1.07, 1.12; Carrington & Sutherland, *supra* note 273; note 348 *infra*. One commentator has suggested that the new skeleton-type professional association statute may indicate that the business corporation statutes are unnecessarily detailed, although he suspects that the corporation statutes will be looked to as a guide in settling some of the many problems raised in the operation of the new entities. Manning, "The 1961 Amendments to the Connecticut Corporation Acts," 35 *Conn. B.J.* 460, 475 (1961).

<sup>298</sup> Treas. Reg. § 301.7701-2(g)(1) (1960) gives an example of an organization of doctors classified as an association which does not have limited liability but does have associates, joint-profit objective, centralized management, continuity of life and a modified form of free transferability. See also Treas. Reg. §§ 301.7701-2(g)(5), (6) (1960); Colony Medical Group, Special Ruling, 7 CCH 1961 Stand. Fed. Tax Rep. ¶ 6375 holding the clinic to be an association although it lacked free transferability of interests; see also note 300 *infra*.

corporate resemblance test was construed to give some weight to partial possession of the characteristics defined by the regulations, an organization might qualify even if it lacked more than one characteristic.<sup>299</sup> For example, some significance could be given to an attenuated limited liability, to continuity of the enterprise, but not the entity, to centralized management of administrative but not professional affairs, to transfers permitted only after approval of the members or a licensing agency, and to the other miscellaneous corporate attributes previously discussed.<sup>300</sup>

The extent to which lawyers and other professionals may successfully employ the new state statutes to gain entity status under the tax laws depends in large measure on the attitude of the administrators in the Internal Revenue Service. The barriers and delays which professionals seeking tax rulings have thus far encountered may indicate a hostile or at best a cautious attitude.<sup>301</sup> On the other hand, the recent amendments

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The Connecticut statute is unique in that it authorizes the formation of a professional association if the members provide for three out of four of the significant corporate characteristics. Attorneys in Connecticut would be well advised to try to adopt all four as authorized since this will increase their chances of qualification under the tax law, and will avoid the problem of whether a third person without notice who deals with the association would be bound by the association's nonadoption of one of the characteristics. But see Bittker, *supra* note 297, at 22-23.

<sup>299</sup> See Note, 75 Harv. L. Rev. 776, 783-84 (1962).

<sup>300</sup> See the analysis of the various combinations of factors considered by the courts prior to the adoption of the Kintner regulations. Smith, "Associations Classified as Corporations Under the Internal Revenue Code," 34 Cal. L. Rev. 461, 530-35 (1946) concluding that an organization should be classified as an association if, in addition to associates in a joint enterprise with a business purpose, it has a reasonable degree of centralization of management, continuity of life, and less than a total restriction on free transferability; Sneed, "More About Associations in the Oil and Gas Industry," 33 Texas L. Rev. 168, 189-93 (1954) suggesting that to be an association, an organization must have associates, a joint profit objective, continuity of life, centralization of management, plus (1) limited liability and (2) centralization of legal title in a common agent, trustee or entity, or, plus either (1) or (2) and a substantial number of miscellaneous corporate characteristics.

<sup>301</sup> See Rev. Proc. 11, 1961-1 Cum. Bull. 897; Alexander, "Some Tax Problems of a Professional Association," 13 W. Res. L. Rev. 212, 231-35 (1962); Eber, "Professional Service Corporations," 100 Trusts & Estates 758, 760 (1961); Note, 12 Stan. L. Rev. 746, 764-65 (1960); 8 Amer. B. News 2, col. 2 (No. 2, Feb. 15, 1963). Cf., Maier, "Don't Confuse Kintner-Type Associations With New Professional Corporations," 15 J. Taxation 248, 250 (1961); Lyon, "Action in Indiana on Kintner-Type Organizations," 39 Taxes 266, 268 (1961); Ray, "Corporate Tax Treatment of Medical Clinics Organized as Associations," 39 Taxes 73 (1961). When questioned about the status of professional corporations and associations under the tax regulations, Internal Revenue Commissioner Caplin indicated there were many problems and referred to the article by Professor Bittker (*supra* note 297), one of the most outspoken critics of tax aid to professionals through the association approach. N.Y. Times, August 5, 1962, § 3, p. F9, col. 2. See notes 316, 320, 335, 340, 341 *infra* and accompanying text. It may be that the passage of the Self-Employed Individuals Tax Retirement Act of 1962 which provides some tax relief for the professional will cause the IRS to take an even stricter attitude towards permitting further relief through professional associations or corporations. See Note, 48 B.U.L. Rev. 107, 117-18 (1963). But see Colony Medical Group, Special Ruling, *supra* note 298, applying the Kintner regulations to a medical clinic organized under a Connecticut Non-Stock Corporation Act, and concluding that the Clinic could be treated as an association under the tax laws. This ruling is the only one of its kind and is of doubtful precedent value because it is a special letter ruling, was not issued under the present procedure, and was primarily concerned with the status of the doctors for Federal Employment Tax purposes. One student note interprets the issuance of the regulations as substantially approving the philosophy of the Kintner case and indi-

to the Treasury Department regulations to allow otherwise qualified employees of corporations or other organizations to practice before the IRS indicate that the new statutes are being given effect for some purposes.<sup>302</sup> However, the Treasury Department was careful to point out that the amendments are not intended in any way to affect the determination of the nature of professional corporations or associations for income tax purposes.<sup>303</sup>

The Kintner regulations were designed both to prevent partnership-like entities from being taxed as corporations and to enable the IRS to tax corporate-like entities as corporations even though they resisted such classification.<sup>304</sup> It is hoped that the service will not adopt a policy which discriminates against the taxpayer in every instance by strictly construing the corporate resemblance criteria when applied to professionals and more loosely construing them when applied to oil and gas enterprises and others seeking to avoid association status.<sup>305</sup>

Some commentators have maintained that a professional organization might qualify as an association under the tax laws notwithstanding the Kintner regulations. This contention rests on two debatable theories. The first is that the regulations are invalid because of their reliance on local law.<sup>306</sup> It is true that income tax classifications are federal in nature and should not depend upon local variations, but this principle is not violated by the regulations.<sup>307</sup> Organizations which possess similar characteristics, regardless of their classification under state law, will be treated the same for tax purposes. Thus, an organization which is designated as an association under one state's law although it does not have continuity of life or limited liability, is not the same as an association

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cating that the IRS is favorably disposed to giving tax relief to professionals. On this basis, he suggests that the regulations may be amended to make it easier for organizations under the new statutes to meet the tax requirements. Note, 37 *Notre Dame Law* 545, 549 (1962). But see articles cited supra and notes 132, 133 supra and accompanying text.

<sup>302</sup> 27 Fed. Reg. 9918 (Oct. 9, 1962), amending 31 C.F.R. Part 10; see proposed amendments, 27 Fed. Reg. 3611 (Apr. 14, 1962).

<sup>303</sup> *Ibid.*

<sup>304</sup> See Treas. Reg. §§ 301.7701-2(a)(2), (g)(2), (3), (5), (6) (1960); Ray, supra note 301, at 86-87; note 216 supra; cf., Smith, supra note 300; Sneed, supra note 300; Soter, "Taxation of Oil and Gas Financing Arrangements," 31 *U. Cinc. L. Rev.* 1, 3-8 (1962).

<sup>305</sup> See *United States v. Stierwalt*, 287 F.2d 855 (10th Cir. 1961), 110 *U. Pa. L. Rev.* 129 (1961); *John Provence #1 Well*, 37 T.C. 376 (1961). But see *Colony Medical Group, Special Ruling*, 7 CCH 1961 Stand. Fed. Tax Rep. ¶ 6375. See also Ray, supra note 301, at 86-87. While the taxpayer has the burden of proof, he should have an opportunity to try to sustain it before an unbiased tribunal. See Grayck, "Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments," 17 *Tax L. Rev.* 469, 489 (1962).

<sup>306</sup> See e.g., Lyon, supra note 301, at 267; Ray, supra note 301, at 82-87; Comment, 12 *Mercer L. Rev.* 388, 392, 395 (1961). Cf., Mackay, "Pension Plans and Associations Taxable as Corporations for Professional Persons," 10 *Sw. L.J.* 281, 287-88, 291-92 (1956); Note, 37 *Ind. L.J.* 124, 134 (1961).

<sup>307</sup> See Maier & Wild, "Taxation of Professional Firms as Corporations," 44 *Marq. L. Rev.* 127, 137 (1960); Bittker, supra note 297, at 8 n.10. Cf., Note, 31 *U. Cinc. L. Rev.* 71, 73-74 (1962).

under another state's laws which does possess those attributes, and the two types of organizations can be rightfully distinguished for tax purposes. The other theory asserts that the new regulations are invalid because the definition of "association" in the regulations is inconsistent with the interpretation given in *Morrissey* and other cases,<sup>308</sup> and with the old regulations construing the statutory definition of "corporation" in the 1939 Internal Revenue Code which was re-enacted without change in the 1954 Code.<sup>309</sup> The theory that an interpretation of a statute is given the force of law by the re-enactment of the statute without alteration of the interpretation, is, as the *Morrissey* case itself recognized, a flexible doctrine which does not invalidate regulations issued after re-enactment.<sup>310</sup> Although Treasury regulations have been afforded varying weights by the courts,<sup>311</sup> they are usually upheld unless unreasonable or plainly inconsistent with a statute.<sup>312</sup> However persuasively one might

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<sup>308</sup> *Morrissey v. Commissioner*, 296 U.S. 344 (1935); *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); see *Bye & Young*, supra note 260, at 432-34; Comment, 12 *Mercer L. Rev.* 388, 390-91, 395 (1961). The *Morrissey* case, unlike the new regulations, gave significance to the characteristics of associates and a joint-profit objective, and to the fact that an entity was created apart from the members of the organization. The *Kintner* regulations afford weight to the former two characteristics when determining whether an entity is a trust or an association but not a partnership or an association (since the characteristics are essential to both types of enterprise). However, it may be that the application of the *Morrissey* case (which involved a trust) was similarly limited and that the separate entity factor was given little, if any, weight. See *Smith*, supra note 300, at 529-30, 533. But see *Sneed*, supra note 300, at 189-90. See also note 144 supra.

<sup>309</sup> *Treas. Reg.* 111, § 29.3797-2 (1943), readopted as, *Treas. Reg.* 118, § 39.3797-2 (1953). See *Maier & Wild*, supra note 307, at 141. Under the old regulations, the most significant characteristics were continuity of life (often interpreted as continuity of the enterprise) and centralization of management. See *Edwards*, supra note 293; *Smith*, supra note 300, at 530; Note, 12 *Stan. L. Rev.* 746, 759-60 (1960). These characteristics would be easier for a professional organization to attain than the now equally important characteristics of limited liability and free transferability of interests.

<sup>310</sup> As the statute merely provided that the term "corporation" should include "associations," without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision. . . . We find no ground for the contention that by the enactment of the Revenue Act of 1924 the Department was limited to its previous regulations as to associations.

*Morrissey v. Commissioner*, 296 U.S. 344, 354-55 (1935). See *Helvering v. Wilshire Oil Co.*, 308 U.S. 90, 100-01 (1939); 1 *Davis*, *Administrative Law* §§ 5.07-10 (1958). The reenactment doctrine would only seem to be valid, if at all, where it could be shown that Congress actually considered the existing regulations or court decisions and decided not to make any changes in light of them. See 1 *Davis*, supra, at § 5.07; *Brown*, "Regulations, Reenactment and the Revenue Acts," 54 *Harv. L. Rev.* 377 (1941); *Feller*, "Addendum to the Regulations Problem," 54 *Harv. L. Rev.* 1311 (1941); *Griswold*, "A Summary of the Regulations Problem," 54 *Harv. L. Rev.* 398, 400-04 (1941); *Griswold*, "Postscriptum," 54 *Harv. L. Rev.* 1323 (1941); *Surrey*, "The Scope and Effect of Treasury Regulations Under the Income, Estate and Gift Taxes," 88 *U. Pa. L. Rev.* 556 (1940); cf., *Commarano v. United States*, 358 U.S. 498, 510-11 (1959).

<sup>311</sup> See 1 *Davis*, supra note 310, at 317-19, 321-24.

<sup>312</sup> *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948); see 1 *Davis*, supra note 310, at 318-19, 321-24; *Eisenstein*, "Some Iconoclastic Reflections on Tax Administration," 58 *Harv. L. Rev.* 477, 528 (1945); cf., *Lykes v. United States*, 343 U.S. 118, 127, 129 (1952); *Griswold*, supra note 310, at 404-11; see also Note, 31 *U. Cinc. L. Rev.*

argue that the old cases and regulations employed more desirable criteria than do the Kintner regulations,<sup>313</sup> it cannot be fairly said that they are unreasonable or inconsistent with the undefined terms used in the statute. Unless a particular court strongly opposes the policy of the regulations,<sup>314</sup> it seems likely that the Kintner regulations will be approved as the tests to be used in determining whether or not the new professional organizations qualify as associations under the tax laws. Nevertheless, on the basis of the only court decisions thus far considering the tax status of professional associations,<sup>315</sup> we would expect the courts, unlike the Internal Revenue Service, to construe the regulations favorably to the taxpayer.

### III

#### EVALUATION

The successful use of the professional corporation will undoubtedly help the rich lawyer (a relatively rare breed) to get richer. It may even increase the downward trickle of financial benefits. But clearly this is insufficient reason to encourage its use and acceptance. What of the effect on professional responsibilities? On the tax policy? On the law of business associations? The problems and uncertainties in these areas have prompted one tax authority, Professor Boris Bittker, to wave the red flag and advise the Treasury Department and the federal courts to resolve doubts against the new entities and deny corporation classification or at least to abstain from decision until the states have developed a corpus of private law.<sup>316</sup> Other writers, while more sympathetic to the desire of professionals for tax relief, have suggested that it may be a wise compromise to accept the lesser benefits under H.R.-10 than enter the twilight zone of professional corporations.<sup>317</sup> The present writers,

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71, 74-75, 77 (1962) stating that the regulations are interpretive and could be attacked as unreasonable but that they are not in fact unreasonable. Despite statutory authorization to issue regulations (IRC § 7805) on the basis of the legislative history of the Code, most tax regulations are considered interpretative rather than legislative, and thus, not entitled to "the force of law." See 1 Davis, *supra* note 310, at 310-11 and authorities cited at 313 nn.25-28.

<sup>313</sup> See e.g., Ray, *supra* note 301; Note, 12 Stan. L. Rev. 746, 760-61, 764 (1960); cf. Smith, *supra* note 300; Sneed, *supra* note 300.

<sup>314</sup> See 1 Davis, *supra* note 310, at 317, 319 noting that the degree of the judge's agreement or disagreement with the regulation is one of the most important factors determining how much respect the judge will give the regulation. In view of the Kintner and Galt decisions, *infra* note 315, it would not be shocking to find some courts disregarding the Kintner regulations.

<sup>315</sup> Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959); Kintner v. United States, 107 F. Supp. 976 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954); see also Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936); note 314 *supra*.

<sup>316</sup> Bittker, *supra* note 297, at 25, 28-34. But see note 297 *supra*.

<sup>317</sup> E.g., Comments, 12 Mercer L. Rev. 388, 400 (1961), 16 Sw. L.J. 462, 505-06 (1962); 14 Syracuse L. Rev. 104, 106 (1962). Cf., Editorials, 84 N.J.L.J. 512 (1961), 27 U.P. News 183 (No. 2, 1961).

however, view the matter differently. We regard the advent of the professional corporation as providing an opportunity to evaluate some neglected or ignored policy considerations in the fields of professional responsibility, taxation and business associations.

Thirty years ago it was stated that "the economic demand for the incorporation of law firms as such is very slight."<sup>318</sup> The income tax laws have now provided the economic incentive, and this has given rise to increased interest in evaluating the traditional prohibitions on the practice of law in corporate form. On the basis of our analysis, it seems that these prohibitions are based more on a restricted doctrinal approach to legal ethics and the law of business associations than on realistic considerations. The Supreme Court of Florida has aptly observed that:

Traditionally, prohibition against the practice of a profession through the corporate entity has been grounded on the essentially personal relationship existing between the lawyer and his client, or the doctor and his patient. This necessary personal relationship imposes upon the lawyer a standard of duty and responsibility which does not apply in the ordinary commercial relationship. The non-corporate status of the lawyer was deemed necessary in order to preserve to the client the benefits of a highly confidential relationship, based upon personal confidence, ability, and integrity. If a means can be devised which preserves to the client and the public generally, all of the traditional obligations and responsibilities of the lawyer and at the same time enables the legal profession to obtain a benefit not otherwise available to it, we can find no objection to the proposal.<sup>319</sup>

The attempts of the states to devise this means are not perfect but neither do they miss the mark entirely. It is apparent to us that the all-lawyer corporation with express provisions insuring the preservation of the full-measure of the attorney's professional relationship, responsibility and liability would not be appreciably different from many existing law partnerships.

Professor Bittker contends, however, that aside from the questionable effect of the state laws on professional responsibilities, the states should not be able to alter federal tax incidents merely by changing the label on a form of doing business.<sup>320</sup> While this position has merit, it is not the state legislation that is to blame but the federal income tax laws which permit such labels to determine tax liability. Moreover, the Kintner regulations in defining the label, "association," invited the states to

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<sup>318</sup> Note, 44 Harv. L. Rev. 1114 (1931).

<sup>319</sup> Matter of The Florida Bar, 133 So. 2d 554, 556 (Fla. 1961). Compare the attitude of other lawyers who fear a too hasty tinkering with professional relationships as a result of an undue concern for tax benefits. E.g., Bittker, *supra* note 297, at 2-3, 28-30; "The Day Law Firms Went Public," 5 N.J.S.B.J. 865 (1962); Editorials, 84 N.J.L.J. 512 (Sept. 28, 1961), 27 U.P. News 183 (No. 2, 1961); see also notes 167, 264 *supra*.

<sup>320</sup> Bittker, *supra* note 297, at 28-30, 31-32, 34-35. See Note, 75 Harv. L. Rev. 766, 792-94 (1962).



act by making the presence or absence of the essential corporate characteristics dependent on local law.<sup>321</sup> The approach of the regulations and in general of the courts which have construed these labels has been purely conceptual: Under the tax laws a corporation is treated in X manner *e.g.*, it may deduct contributions made to a qualified pension plan, a typical business corporation—typical by common law standards, that is—has certain characteristics,<sup>322</sup> the ABC Organization has more of these characteristics than it lacks, therefore we will treat the ABC Organization as if it were a corporation and tax it in X manner.

This approach is inadequate in terms of modern business association law and tax policy. It ignores why a corporation is taxed in X manner, and ignores the policy behind the provision providing for taxation in X manner and whether the taxation of all corporations in X manner is within that policy. What is needed is a functional approach where a corporation or other form of business organization is looked upon as a "method" not as a "thing."<sup>323</sup> Under this approach the concern is over what a corporation does and why, not the metaphysics of what a corporation is.<sup>324</sup> Thus instead of classifying the "thing" and letting the tax consequences be determined by the label, the appropriate tax policy is first found and then the tax consequences are adjusted as to each business method in a manner consistent with the tax policy.

To illustrate, let us analyze the taxation of corporations in the referred to X manner, *i.e.*, the permitted deduction of contributions made to a qualified pension plan. Why can a corporation take such deductions? Apparently because it is an employer of employees. What makes

<sup>321</sup> Treas. Reg. § 301.7701-1(c) (1960).

<sup>322</sup> *E.g.*, *Morrissey v. Commissioner*, 296 U.S. 344 (1935); Treas. Reg. § 301.7701-2(a)(1) (1960). Professor Bittker recognizes the conceptual nature of this approach but, nevertheless, feels constrained to employ it. Bittker, *supra* note 297, at 3 n.5. The extreme degree of conceptualism in the Kintner regulations is illustrated by their requirement of continuity of the life of the entity rather than that of the enterprise. See note 218 *supra*. The concern should be with the kind of organization that was in fact contemplated. See *United States v. Stierwalt*, 287 F.2d 855 (10th Cir. 1961), 110 U. Pa. L. Rev. 129 (1961); note 324 *infra*.

<sup>323</sup> *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 118-19, 222 N.Y.S. 532, 543-44 (Sup. Ct. N.Y. County 1927); Henderson, *The Position of Foreign Corporations in American Constitutional Law* 22, 166-68 (1918); Manning, "Corporate Power and Individual Freedom: Some General Analysis and Particular Reservations," 55 *Nw. U.L. Rev.* 38, 39 (1960); 2 *Corp. Prac. Conm.* (No. 4) 26, 28 (1961): "A 'corporation' is a way of filing papers, attended by certain more or less predictable special legal consequences of an increasingly narrow significance."

<sup>324</sup> See *Farmers' Loan & Trust Co. v. Pierson*, *supra* note 323, at 114-19, 222 N.Y. Supp. at 538-44; Henderson, *supra* note 323, at 50, 165-68; Cohen, "Transcendental Nonsense and the Functional Approach," 35 *Colum. L. Rev.* 809 (1935); Green, "Corporations As Persons, Citizens and Possessors of Liberty," 94 *U. Pa. L. Rev.* 202, 202-04, 205-06, 209-10 (1946); Harbrecht & McCallin, "The Corporation and the State in Anglo-American Law and Politics," 10 *J. Pub. L.* 1, 44 (1961); Note, 23 *U. Pitt. L. Rev.* 172 (1961); see also *United States v. Goldberg*, 206 F. Supp. 394, 405 (E.D. Pa. 1962); *Tucker v. Binenstock*, 310 Pa. 254, 263, 165 *Atl.* 247, 250 (1933); Dewey, "The Historic Background of Corporate Legal Personality," 35 *Yale L.J.* 655, 660-63, 669-73.

it so? Continuity of life? Hardly. Limited liability? Wholly unlikely. Free transferability? Very doubtful. Centralization of management? Perhaps in part. Recognition as a separate legal entity? This is apparently the most basic reason why a corporation can be an employer. Yet the regulations ignore this characteristic. Should we therefore conclude that any method of doing business, including a partnership,<sup>325</sup> which is recognized as a legal entity should be taxed in the same manner as a corporation? Clearly not for purposes other than the deductibility of contributions made to a pension plan, and not even for that purpose until we determine whether this result will carry out the policy behind the tax code provisions. In making our determination we may even discover that not all corporations and their employees were intended to be benefited by these provisions, that small closely held corporations should be treated differently than large publicly held corporations, that the law was passed for the advantage of minimum wage employees but not high salaried executives or, on the other extreme, that all taxpayers who performed personal services were within the benefited class regardless of their form of business or whether they were employees in a legalistic sense. In other words the inquiry has little or nothing to do with the label, we are not concerned with what is or is not a corporation, but with what is the reason certain tax consequences were provided for and who should benefit from them, and how can the policy of the provisions best be carried out.

It should come as a shock to no one that the federal tax laws have many purposes other than that of producing revenue. Because of their great fiscal impact, the tax laws provide the government with a most effective means of economic and social control, and thus, their real meaning and purpose can begin to appear only when they are viewed in the context of the desired economic goals and related social objectives. In examining a particular tax code provision we need not be restricted by its historical justification, although that may provide a starting place for an evaluation of the provision in light of today's desires and expectations. The pension plan provisions of the Internal Revenue Code have been part of our tax laws for many years and their original purpose could not be expected to settle all problems of application to the continuously

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<sup>325</sup> A partnership has been recognized as a legal entity for many purposes including that of an employer of the working partners. *Scott v. Alsar Co.*, 336 Mich. 532, 58 N.W.2d 910 (1953); *Chisholm v. Chisholm Construction Co.*, 298 Mich. 25, 298 N.W. 390 (1941); *Finston v. Unemployment Compensation Comm'n*, 132 N.J.L. 276, 39 A.2d 697 (Sup. Ct. 1944), *aff'd sub nom. Naidech v. Unemployment Compensation Comm'n*, 134 N.J.L. 232, 46 A.2d 734 (Ct. of Err. & App. 1946); see *Crane, Partnership* § 3 (2d ed. 1952); *Stevens, Private Corporations* § 7 (2d ed. 1949); *Note*, 41 Col. L. Rev. 698 (1941). See note 177 *supra*.

changing conditions of our society.<sup>326</sup> Thus, the particular distribution of values intended to be effected by the provisions is to some extent unknown, but we believe that certain general policies are discernible.

The basic governmental purpose in giving favorable tax treatment to amounts contributed or set aside for retirement purposes is not to lessen the tax bite for low or high bracket taxpayers. If tax relief were the chief motivation, then a direct reduction of rates would be a simple means to accomplish the result. Instead, we believe that the touchstone of the retirement plan provisions will be found in the basic inequality or tax differential in our federal tax structure between income earned by personal services and income attributed to capital investment.<sup>327</sup> Those who derive their income substantially from capital wealth generally can spread it relatively evenly over their lifetime. Age 65 is merely another birthday for those who have no need to know what the word retirement means. On the other hand, those who support themselves by performing personal services are more likely to bunch their earnings in a significantly shorter period of time. They will, thus, be more heavily hit by a graduated tax structure than their coupon-clipping counterparts. There are several ways in which our tax laws could attempt to equalize this differential. The double personal exemptions, the unlimited medical expense deduction, and the retirement income credit are all available to the elderly taxpayer, but curiously enough, whether he obtains his earnings from capital wealth or personal services. The primary means, then of shortening this tax gap between those who depend on personal service income and those who do not is the encouragement of the private, non-governmental, pension or profit-sharing plan. The private plan is expected to be a supplement to the basic or minimum public retirement systems. It is intended, with the aid of the tax code, to serve as an averaging device for those who can set aside or have set aside for them a portion of their earnings in their younger and more productive years for enjoyment in their older and retirement years.

A collateral yet important objective of the deferral of earnings to post-retirement years would be to reduce the burden of the government in providing a fuller economic life (through social security or other means)

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<sup>326</sup> For summaries of the history and reasons for the growth of private pension plans and their encouragement through the tax laws, see e.g., Dyer, "Federal Tax Treatment of Pension and Other Employee Benefit Plans," *Tax Revision Compendium*, Vol. 2, 1375; Holland, "Some Characteristics of Private Pension Plans, House Comm. on Ways and Means," *id.* at 1301 (Comm. Print 1959); Specter, "Pension and Profit Sharing Plans: Coverage and Operation for Closely Held Corporations and Professional Associations," 7 *Vill. L. Rev.* 335, 338 (1962).

<sup>327</sup> See Morrison, "Income Taxation of Savings for Retirement," *Tax Revision Compendium*, *supra* note 326, at 1337; *cf.*, Dyer, *supra* note 326, at 1375; Seligman, "Pension and Other Employee Benefit Plans," *id.* at 1353.

to those who would come to seek aid from public funds.<sup>328</sup> This latter objective was considered a most significant one in the face of criticism of the "welfare state" movement, which gained great momentum in the 1930s. In order to make peace with industry and to encourage it to provide and administer funds for the retirement needs of its working force, the government developed a philosophy of helping those who help others.<sup>329</sup> Consequently, the affluent executive employee was permitted to be included along with the more needy low or medium wage earner in the group benefited by the retirement plan provisions of the tax code. Although the executive or highly compensated person was not likely to become a financial burden on the government in his retirement years, the inclusion of this class of persons was consistent with the objective of minimizing the income tax liabilities of personal service earnings as compared with income derived from capital.

While these pension and profit-sharing plan tax benefits have been part of our law for many years, it was not until the high tax rate structure was adopted in the World War II period that many taxpayers became aware of the sizable relief available.<sup>330</sup> Although the greater part of the nation's working force fell within the magical label, "employee," and were thus eligible for the benefits,<sup>331</sup> self-employed persons (partners and sole-proprietors) who were not technically employees within the common-law tradition and who could not or would not change their formal entity arrangements were unable to take advantage of the benefits. These self-employed persons, however, were also within the class that derived their earnings from personal services and were deserving of some tax equalization with the capital wealth class. Nevertheless, the Treasury Department opposed the entrance of the self-employed person into the pension and profit-sharing plan arena. Their reasoning was apparently two-fold. First, the self-employed person and especially the professional was said not to be looking to provide for his retirement needs, but rather to obtain a device to minimize his current tax liability. However true this may be of some self-employed persons, it is not likely to be true of the majority of lawyers who upon reaching retirement age

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<sup>328</sup> See e.g., Lesser, "Pension and Other Employee Benefit Plans," *id.* at 1383-84; Seligman, *supra* note 327, at 1353, 1354-58.

<sup>329</sup> See McConnell, "Treatment of Pension Plans," *id.* at 1347-49.

<sup>330</sup> World War II was also a period of wage controls and many employers turned to pension plans as a means of giving additional compensation to their employees. For these and other reasons asserted for the growth of private pension plans, see Holland, *supra* note 326, at 1301; Lesser, *supra* note 328, at 1383; McConnell, *supra* note 329, at 1347-48; see also note 326 *supra*.

<sup>331</sup> Despite this eligibility, the large majority of employees are not presently covered by private pension plans. This is also a legitimate concern for the tax policy planner. See Bittker, *supra* note 297, at 34; Holland, *supra* note 326, at 1301, 1306-09; McConnell, *supra* note 329, at 1347-48. See also notes 350-52 *infra*.

find that the canons of ethics prohibit them from selling the practice which they have struggled to build-up,<sup>332</sup> and likely face the prospect of continuing to work in order to eat. Moreover, this same argument, even if valid, could also apply with greater force to the bulk of corporate executives and other highly compensated members of the protected "employee" group.<sup>333</sup> In addition, one reason for extending pension plan tax benefits to highly paid manager-employees was to encourage them to set up retirement programs for the run-of-the-mill employee. This same reasoning ought to apply to employees of self-employed persons (*i.e.*, non-corporate employers) who, though technically capable of being covered by employee pension plans, are often and realistically denied such coverage because the employer lacks sufficient incentive to set up a plan under which he can not be included.<sup>334</sup>

A second Treasury Department objection to the inclusion of the self-employed within the pension plan tax shelter was the age-old cry of loss of tax revenue. Obviously this argument is applicable to the entire employee retirement plan concept and lacks validity when applied only to professionals or other self-employed persons or only to loss of revenue through retirement plans and not through other special tax benefits. Professor Bittker and others have criticised the attempts of the professional people to come under the pension plan benefits of the tax code because they seek to obtain special benefits not available to other taxpayers, and because this would open the door to other special interest groups seeking similar preferential treatment.<sup>335</sup> As previously observed, the tax laws have been frequently used as a means of social and economic control, and tax favoritism to foster certain welfare programs such as pension plans or certain industries such as oil and natural resources is not evil merely because it curtails the amount of collectible tax revenue. It is bad only when the revenue losses are not outweighed by the social and economic gains resulting from the tax benefit. The late Senator Kerr recently defended so-called "loopholes" in our tax laws which provide depletion allowances for oil recovery companies, stock options for corporate managers, deductions for expenditures for good-

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<sup>332</sup> See notes 275-82 *supra* and accompanying text.

<sup>333</sup> Owner-employees of a one man or closely held corporation may take advantage of the pension or profit-sharing plan provisions. See note 213 *supra*; Byron, "Profit-Sharing Plans for the Closely Held Corporation," 40 *Taxes* 47 (1962) explaining that the provisions intended to benefit the needy are also available to the greedy. The use of "retirement" provisions as a tax deferral and savings device by those not in need of retirement funds, whether by executive employees or self-employed persons, has been criticized. See *e.g.*, Lesser, *supra* note 326, at 1383, 1384-88. In addition, corporate executives often have opportunities to increase their income through favorable capital investments. See Griswold, "The Mysterious Stock Option," *id.* at 1327. See also note 351 *infra*.

<sup>334</sup> See Dyer, *supra* note 326, at 1375, 1379; see also note 329 *supra*.

<sup>335</sup> Bittker, *supra* note 297, at 34-35; *cf.*, Lesser, *supra* note 328, at 1383, 1386-87.

will, split-income provisions for married taxpayers, dividend credits for investors, capital gain rates for property owners and investors, pension plan and other benefits for the aged, and certain other special interest tax legislation.<sup>336</sup> He stated:

I think each of the present provisions serves a worthy purpose. They encourage home ownership, stimulate investment, promote development of our natural resources, remove inequities or benefit the aged or handicapped.<sup>337</sup>

Thus, in determining whether a tax benefit should be bestowed on a particular group, several factors should be weighed, including the anticipated loss of tax revenue, the social or economic gain expected, the existing tax benefits or burdens applied to the group seeking the benefits and to other groups which might be considered to be in an analogous category, the difficulty of administration, and, perhaps, the likely political acceptance. In terms of the pension plan benefits for professional folk, the inquiry might well be: Are they seeking to open wider a tax loophole which should be closed as to other persons now enjoying it, or, upon a weighing of all the relevant factors, are the professional persons deserving of the benefits just as persons in analogous positions are?<sup>338</sup>

While we recognize the desirability of benefiting the capital investor in order to stimulate the economy, we also believe that it is in the national interest to aid the taxpayer who depends on personal service earnings, whether as an employee or employer, when those earnings are declining in his later years.<sup>339</sup> The professional corporation or association will permit many such persons, who were previously ineligible, to be benefited by the provisions carrying out this policy. Nevertheless, it is the position of Professor Bittker that Congress has had ample opportunity to permit taxation of professionals as employees of a corporation and has uniformly refused to do so.<sup>340</sup> He states:

I do think, however, that state legislation designed to outflank Congress and the Treasury ought not to be encouraged, especially when it is directed at a problem under active Congressional study, and has so meager a non-tax content as to be virtually devoid of business purpose.<sup>341</sup>

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<sup>336</sup> Kerr, "Tax Loopholes: fact or myth?" *Look*, March 13, 1962, p. 92.

<sup>337</sup> *Id.* at 96, col. 4.

<sup>338</sup> Evaluations of the social and economic justifications of several provisions of the IRC including those relating to pension plans will be found in the *Tax Revision Compendium*, *supra* note 326. See e.g., *id.* at 1301-95 (pension plans).

<sup>339</sup> See Cliffe & Marshall, "Financial Freedom and a Dynamic Economy," *id.* at 1391. The authors appropriately note that the funds set aside under pension plans become available for private capital investment. See also, Morrison, *supra* note 327, at 1337, 1342; Seligman, *supra* note 327, at 1353, 1360.

<sup>340</sup> Bittker, *supra* note 297, at 30-31.

<sup>341</sup> *Id.* at 32.

Basing congressional intent upon the inaction of Congress is a questionable practice,<sup>342</sup> and its inadequacy is demonstrated in this case by the subsequent attempt, albeit a half-hearted one, to cater to the retirement needs of the professional by the passage of the Self-Employed Individuals Tax Retirement Act of 1962. Furthermore, while it is true that the motivating purpose of the new state statutes was tax savings, this should not destroy their validity.<sup>343</sup> As previously indicated, the state legislation was not designed to outflank Congress but was merely an attempt to pick up the buck passed to the state by Congress in drafting the tax code and by the Treasury in its interpretation of it. We agree with the Florida court's opinion that:

This state legislation and those who seek to meet its requirements are not to be catalogued as devious or evasive. We construe the legislation . . . as a frank and forthright effort to adapt certain business and professional relationships to the requirements of the Internal Revenue Service in order that the members of such businesses or professions may be placed on an equal footing with other taxpayers.<sup>344</sup>

It is common knowledge that many organizations choose their business form with tax consequences in mind,<sup>345</sup> and professional persons should be subject to no greater condemnation for seeking the creation of a new entity which will give them an equal opportunity for choice. Moreover, there are non-tax benefits of practicing a profession in a corporate form,<sup>346</sup> and these new entities will serve a useful social purpose

<sup>342</sup> See Grayck, *supra* note 305, at 485-86. There also are indications that Congress and the Treasury Department are interested in liberalizing the pension plan provisions to benefit more taxpayers who render personal services. See IRC § 403(b), as amended, 75 Stat. 801 (1961) (extending benefits to employees of public educational institutions); Rev. Rul. 62-139, 1962 Int. Rev. Bull. No. 34 (liberalizing past service credits).

<sup>343</sup> *Contra*, Bittker, *supra* note 297, at 28-30; see also Alexander, *supra* note 301, at 224-25. Professor Bittker's position has been challenged on two grounds. One, if Congress objects to the federal tax incidents of the state legislation, it can change the tax laws accordingly. Two, Bittker is engaging in circular reasoning by saying it is doubtful whether the new entities satisfy the Kintner regulations, these doubts should be resolved against the state statutes because they try to effect federal tax policy, and the state statutes should not be permitted to effect federal tax policy because it is doubtful whether they meet the Kintner regulations. Grayck, *supra* note 305, at 484-85. See also notes 320-21 *supra* and accompanying text.

<sup>344</sup> *Matter of The Florida Bar*, 133 So. 2d 554, 556 (Fla. 1961).

<sup>345</sup> See Rohlich, *Organizing Corporate and Other Business Enterprises* § 5.05 (3d ed. 1958); Maier & Wild, *supra* note 307, at 142: "The tax tail is often so important that it wags the dog as to the selection of the proper form of organization."

<sup>346</sup> The benefits of practice as part of a group rather than as an individual include: greater financial return, consultation with associates, opportunity for division of labor and specialization, continuous service available to clients, team spirit tending to increase morale, and, as indicated by recent surveys, greater adherence to the Canons of Ethics. See Cheatham, *Legal Profession* 211-16, 487-89 (2d ed. 1955); Carrington & Sutherland, *Articles of Partnership for Law Firms*, ABA Economics of the Law Practice Series, Pamphlet No. 6, 7-9. The professional corporation retains these benefits and may additionally provide more efficient management and administration, and facilitated retirement or withdrawal from a firm. See Eber, *supra* note 301, at 759; Jones, "Should Lawyers Incorporate?" 11 *Hastings L.J.* 150, 156 (1959); Kahn, "The Wisconsin Service Corporation Law of 1961," 1962 *Wis. L. Rev.* 65, 81; Comment, 12 *Stan. L. Rev.* 746, 752-53 (1960). If corporate status is attained under the tax laws, this will encourage the establishment of pension plans which may in turn aid employee efficiency and loyalty, decrease turnover, and improve retirement conditions. See Specter, *supra* note 326, at 336.

by providing the professional with a method of doing business which will not offend traditional professional relationships, and at the same time, will permit him to enjoy many of the tax and other advantages of the corporation.<sup>347</sup> The label which the states assign to this new method of doing business is of relatively little importance. Like the close corporation to which they bear much resemblance,<sup>348</sup> the professional corporations and associations provide a variation of the "ordinary" business corporation in order to accommodate it to another economically feasible and socially desirable business arrangement. Thus, consistent with our view of the functional approach to the law of business associations and taxation, we believe that the new professional entities are worthy of recognition, not as a devious means to an undeserved end, but as a novel method of removing the traditional barriers to the carrying out of a sound tax policy.

The professional corporation or association, however, is not a completely satisfactory answer to the tax problems of the professional. Since most professional persons, and certainly lawyers, could not use "dummy" incorporators in forming an association or corporation, the sole practitioner will not be benefited by the new state legislation. Furthermore, many states may elect not to authorize formation of the new entities, and the tax discrimination may be increased rather than diminished.<sup>349</sup> Thus, we believe that a more satisfactory solution can be provided by new federal legislation. The Keogh Bill as proposed was at best incomplete relief, and as passed in the form of the Self-Employed Individuals Tax Retirement Act of 1962 is wholly inadequate. It has been seen that

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<sup>347</sup> The social utility of a reevaluation of the traditional prohibitions on the practice of law in corporate form had been recognized by several commentators prior to the tax incentive to achieve corporation status. See e.g., Cheatham, *supra* note 346, at 493-501; Note, 44 *Harv. L. Rev.* 1114 (1931); authorities cited at notes 169-71 *supra*.

<sup>348</sup> See 1 O'Neal, *Close Corporations* §§ 1.02, 1.07, 1.12 (1958); Conway, "The New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures," 30 *Fordham L. Rev.* 297, 303-06, 320, 323-24 (1961); Specter, *supra* note 326, at 358. The professional corporation and association statutes may be evidence of a further breaking down of the traditional categories of "corporation," "partnership" and "sole proprietorship" toward the evolution of integrated General Business Association Acts. See Manning, "The 1961 Amendments to the Connecticut Corporation Acts," 35 *Conn. B.J.* 460, 475-76 (1961).

<sup>349</sup> See Bittker, "Professional Associations and Federal Income Taxation: Some Questions and Comments," 17 *Tax L. Rev.* 1, 31-32 (1961); Note, 75 *Harv. L. Rev.* 776, 792-94 (1962). But see Grayck, *supra* note 305, at 487-88 contending that this is an matter of state concern, and that tax treatment of the business structures will be uniform from state to state and consistent with that of a business organization and its employees. The lack of uniformity in the state authorization of business structures and the consequent different tax treatment of professional persons has been compared to the attempt of several states to gain tax benefits for their citizens by adopting community property laws, which in turn prodded Congress to amend the tax laws to bring about uniform treatment of married couples. It was the hope of some that history would repeat itself and that Congress would react to the professional corporation statutes by passing the Keogh Bill or other tax relief for professionals. If these would-be prophets take comfort in the passage of the Self-Employed Individuals Tax Retirement Act of 1962, they are being deceived by the rose color in their crystal balls.



the aim of the professional is to attain employee status under the tax laws. This could be provided by a simple change in the definition of "employee" to include one who is self-employed or a partner or other type of associate in an unincorporated business organization.<sup>350</sup> This would avoid the complex and confusing provisions of the 1962 amendment as well as those of the Kintner regulations, and would permit the professional person to take advantage of the same pension plan and other tax benefits now available to other personal service taxpayers who are not prevented by law or ethics from becoming corporate employees. It would also lessen the influence of tax considerations in choosing a business form and would encourage the establishment of pension plans for the benefit of employees of non-corporate enterprises.

Even this solution is far from a tax panacea. It leaves unresolved the problem of aiding the retirement needs of millions of non-professional taxpayers who are not now covered by adequate pension plans, and it fails to curtail certain abusive practices under the pension plan provisions of the tax code.<sup>351</sup> But we are less concerned with providing optimum solutions to specific tax problems than with reorienting the traditional methods of tax administration. We have tried to demonstrate why and how a functional pragmatic approach should be substituted for taxation by conceptual label. This requires a re-evaluation of the various tax benefits now made available to determine what the policy supporting each benefit is, whether it is socially and economically justified, and whether the provisions of the code best effectuate the policy while

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<sup>350</sup> See Maier & Wild, *supra* note 307, at 142; Specter, *supra* note 326, at 356, 358; Comment, 12 *Stan. L. Rev.* 746, 747 (1960) Note, 37 *Ind. L.J.* 124, 139 (1961). A more conceptual but less comprehensive alternative would be to permit a partnership to be treated as an entity under the pension plan provisions (as it is for certain other tax purposes) and thus become capable of being the employer of the partners and other employees. See Specter, *supra*; notes 177, 325 *supra*. Another avenue to the same place would be to permit a professional partnership to elect to be taxed as a corporation under Subchapter R of the Code. See Carrington & Sutherland, *supra* note 346, at 72-73. Still another approach to end the tax discrimination is outlined in note 351 *infra*.

<sup>351</sup> In addition to incomplete coverage, see note 331 *supra*, the abuses have been alleged to include: failure of pension funds to vest in the employee, stock options, inconsistent taxation of benefits when received especially regarding capital gains treatment of lump sum payments, and lack of controls on investment of pension funds. See Griswold, *supra* note 333, at 1327; Holland, *supra* note 326, at 1301, 1309-17; Lesser, *supra* note 328, at 1383, 1385, 1388; McConnell, *supra* note 324, at 1347, 1348-50; Morrison, *supra* note 326, at 1337, 1339-42. But see Dyer, *supra* note 326, at 1375; Seligman, *supra* note 327, at 1353.

A proposal which is claimed to correct some of the abuses and permit all taxpayers to be covered whether employer or employee would permit each person to put a percentage of his income (it may be fixed or vary with age) into an approved retirement plan and take a tax deduction for such contribution. The investment income would be tax free until received in retirement. See e.g., Cliffe & Marshall, *supra* note 339, at 1391; Dyer, *supra* at 1379; McConnell, *supra* at 1350; Seligman, *supra* at 1354, 1368. These proposals are questioned, however, because of the fear that they will reduce the incentive for employers to establish pension plans for their employees, and that many employees will not or could not establish plans for themselves. See Lesser, *supra* at 1386.

minimizing its abuse.<sup>352</sup> In terms of our present inquiry this may result in defining a self-employed professional person as an employee for one purpose but not for another. Such an approach lacks doctrinal consistency but substitutes realistic plasticity. After all we no longer live in a syllogistic world (and doubtless never did) and the law performs its societal functions all the better when it takes note of reality with greater frequency and dispatch.

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<sup>352</sup> Tax reform, like the weather, is much talked about, but has little done about it. If this situation is (hopefully) to be changed, the reformers will find much realistic evaluation and information in the Tax Revision Compendium. Useful general discussions are contained at 1-167, and in Eisenstein, *The Ideologies of Taxation* (1961), reviewed, 56 *Nw. L. Rev.* 688 (1962).