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# THE TAX DILEMMA OF THE SELF-EMPLOYED PROFESSIONAL

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## I. INTRODUCTION

Principles of modern taxation, aided and abetted by other economic factors, have made it notoriously difficult for most individuals to set aside, during their productive years, amounts sufficient to provide a decent standard of living once those years are past. Recognizing this problem, Congress, as long ago as 1921,<sup>1</sup> sought to provide relief by according favorable tax treatment to those plans known generally as "deferred compensation" plans. In essence, these plans consist of nothing more than employer contributions which are set aside to be enjoyed by the employee or his beneficiaries at a later time.<sup>2</sup>

Once such a plan has been "qualified" in accordance with the provisions of the Internal Revenue Code and the Treasury Regulations, valuable tax benefits are available. The employee does not have to pay income tax on such contributions (even though they are earned compensation) until such time as he or his beneficiaries actually receive the distribution, or until it becomes subject to his withdrawal.<sup>3</sup> Nor will interest earnings of retirement funds be taxed until withdrawn.<sup>4</sup> Upon withdrawal of these funds, the employee will usually be taxed at ordinary income tax rates,<sup>5</sup> except in certain situations where capital gains rates will apply.<sup>6</sup> The employer is entitled to an expense deduction for these contributions when made regardless of when the employee actually receives the funds.<sup>7</sup>

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1. For the background of federal taxation in this area, see PRENTICE HALL, PENSION AND PROFIT SHARING § 5001 (1962).

2. The basic requirements for a qualified deferred compensation plan are set out in § II of this article.

3. INT. REV. CODE of 1954, §§ 402(a)(1), 403(a)(1). [The Internal Revenue Code of 1954 is hereinafter cited as I.R.C.]

4. I.R.C., § 501(a).

5. I.R.C., § 61(a).

6. I.R.C., §§ 402(a)(2), 403(a)(2).

7. I.R.C., § 404(a).

The obvious benefit of such plans is that an employee can defer the tax on some of the most heavily taxed portions of his income. Because of the progressive tax schedule, deferring income taxation until a later time is particularly beneficial to the highly paid employee, for such an employee is usually in a higher tax bracket during his working years than after retirement. Thus, when employer contributions are made during the high income years, these contributions come off the top of current earnings and escape the higher tax rate. When distribution of the retirement fund is made, the recipient will usually be in a lower tax bracket, having no current earnings or reduced earnings, and consequently the funds will be taxed at a lower rate than they would have had been when set aside.<sup>8</sup>

The tax inequality in this area so often referred to was based upon the fact that deferred compensation plans were not available to self-employed individuals until the passage of the Self-Employed Individuals Tax Retirement Act of 1962<sup>9</sup> In designating those persons for whose "exclusive benefit" a plan could be established, the Code spoke solely in terms of "employees."<sup>10</sup> Although it was (and perhaps still is) arguable that at least a partner, if not a sole proprietor, should be considered an "employee," a series of contrary rulings by the Commissioner<sup>11</sup> was apparently sufficient to dissuade the tax bar from litigating the matter. Thus arose the normally accepted view that partners and sole proprietors were not eligible to participate in a "qualified" plan.

Qualified plans have long been available to employees of corporations, and many businessmen have taken advantage of this by incorporating their businesses and becoming corporate employees. For some, however, this route to qualification was closed by the fact that most states prohibited individuals in the professional occupations from incorporating.<sup>12</sup> Thus the self-employed professional man often found himself at a severe disadvantage tax-wise: he was not considered an "employee," and could not incorporate to become one.

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8. Of course, if the employee, due to wise investments, changes in rates, or some other factor, is actually in a higher tax bracket in his later years and after retirement, any tax benefits from deferring compensation may be eradicated.

9. Public Law 87-792, 76 Stat. 809 (1962).

10. I.R.C., § 401(a).

11. Rev. Rul. 57-163, 1957-1 Cum. Bull. 128, part 2(i)(1); Rev. Rul. 33, 1953-1 Cum. Bull. 287, part 2(b)(1); I.T. 3350, 1940-1 Cum. Bull. 64; I.T. 3268, 1939-1 Cum. Bull. 196.

12. The status of professional incorporation today is discussed in § III B of this article.

Illustrative of this inequality is the example which one author<sup>13</sup> uses to indicate the money-saving aspect of a qualified pension or profit-sharing plan. Assume that a 35 year old, married, practicing lawyer or other self-employed person has a taxable income of \$10,000 after deductions. If he were to earn an additional \$1,000, his tax on the additional amount would be \$260. If he invests the remainder, \$740, each year for thirty years at a 4% compound interest rate he would accumulate a total of \$36,900 by age sixty-five. However, if he were employed by a company, and his employer deposited the same \$1,000 for him in a qualified pension or profit-sharing plan, at the same 4% interest rate, the fund would total \$58,300 at age sixty-five.

As a result of this unequal treatment, requests for income tax deferral have long been voiced by the self-employed. In deference to such a request, it should be noted that the self-employed individual is not seeking preferential treatment; he only wants equality. The self-employed feel, as evidenced by their long and untiring efforts to secure additional legislation,<sup>14</sup> that they too should be allowed tax benefits in providing for retirement. The professional man emphasizes such factors as his late start due to educational requirements, the early lean years of practice, his high earnings over a relatively short period, and the eventual tapering off of his earning capacity. For example, prior to 1962, a forty year old, self-employed man with a wife and two children, in order to retire at age sixty-five at about thirty-six percent of his present \$10,000 income, had to expend approximately \$51,000. On the other hand, an employer needed to contribute only approximately \$19,000

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13. Donohue, *Smathers-Keogh-Simpson Legislation: Retirement Savings for the Self-Employed*, 45 A.B.A.J. 795 (1959).

14. For a history of the movement for additional legislation, see Hamblen, *A Precis of Deferred Compensation Arrangements*, 4 PRACTICAL LAWYER 58 (Nov. 1958); Hoffman, *Tax Planning in Qualified Pension and Profit Sharing Plans*, 5 TAX COUNSELOR'S Q. 189 (1961); Lurie, *How to Achieve Flexibility in Pension and Profit-Sharing Plans*, 8 J. TAXATION 236 (1958); Paulston, *Professional Partnerships Taxable as Corporations*, 35 L.A. B. BULL. 121 (1960); Rapp, *Pensions for the Self-Employed: The Treasury Department—Finance Committee Plan*, 16 TAX L. REV. 227 (1961); Rapp, *The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Koegh Bill*, 14 TAX L. REV. 55 (1958); Silverson, *Earned Income and Ability to Pay*, 3 TAX L. REV. 299 (1947); Stutsman, *How to Organize Professional Men for Corporate Tax Status Under Kintner*, 11 J. TAXATION 336 (1959); Stutsman, *New Kintner Regulations Not Retroactive; Give Specific Criteria to Test Partnership*, 12 J. TAXATION 174 (1960); Winkleman, *Pension and Other Deferred Compensation for the Professional Man*, 4 TAX COUNSELOR'S Q. 155 (1960); Zischke, *The Use of Qualified Pension and Profit Sharing Plans for the Benefit of Small Businesses and Their Owners*, 1961 TUL. TAX INST. 526; 34 FLA. B.J. 197 (1960); 12 W. RES. L. REV. 777 (1961).

over the same period in order to achieve the same retirement benefits for a similarly situated employee under a qualified pension plan.

In all fairness to Congress, on the other hand, it must be noted that the tax benefit which was conferred upon those covered under private pension plans was not the result of any legislative purpose to discriminate in favor of one group. It was based upon simple equity, to prevent employees from having to pay present income tax on funds put aside for them by their employers which would not become available until some years in the future, and possibly not at all, if they died or terminated their employment prior to acquiring a vested interest in the fund. Furthermore, in support of its former position the government pointed out that there would be a substantial revenue loss if it did not get its maximum share during the self-employed's high-earning years. To the self-employed, of course, this argument seemed to ignore the equities, since the government was treating corporate employees, with similar education, skills and duties, in exactly the opposite manner.

## II. GENERAL BACKGROUND

In order to understand fully the ramifications of the area under discussion, it is helpful if one first understands the general background of deferred compensation taxation. For the same reason, a short discussion of the various types of deferred compensation plans, and their advantages and disadvantages to employers and employees, seems in order.

Generally speaking, deferred compensation plans are of three basic types: (1) pension plans, (2) profit sharing plans, and (3) stock bonus plans. In actuality, however, the primary point of distinction is between pension plans and profit sharing plans; the stock bonus plan is simply a type of profit sharing plan in which the benefits are distributable in the stock of the employer company.

The Code reference to the distinction between pension and profit sharing plans is the statement found in section 404 (a) (3), that a plan is not a profit sharing or stock option plan if the amounts to be contributed can be *actuarially determined*. Enlarging upon this, the Regulations provide that a pension plan is one "established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement."<sup>15</sup> It would seem, then, that the distinction could be phrased as one between ends and means, with the emphasis, in the case of a pension plan,

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15. Treas. Reg. § 1.401(b)(1) (1958).

being placed upon the ends. With a pension plan the first determination is of the amount of benefits—the ends—eventually to be received by the employee. Once this has been determined, the contributions necessary—the means—may be determined upon the basis of actuarial computations relative to the employee's expected life span after retirement, etc.<sup>16</sup> A profit sharing plan, on the other hand, places its primary emphasis upon the means. Contributions to the plan are geared to whether or not a sufficient profit is shown for each particular year, and the benefits ultimately realized, instead of being "definitely determinable," will depend upon the employer's profits for the particular years.<sup>17</sup>

Quite obviously, the heart and soul of a "qualified" plan of the above types will be found in its method for providing the funds later to be distributed. While the methods of accomplishing this are almost as numerous as the plans themselves, a generalized listing would include: (1) group insurance annuities, (2) individual insurance annuities, (3) uninsured plans administered through a trust, and (4) combination plans. A trust, however, may be utilized even if the plan is one that might be termed "insured"; the trustee, rather than the employer, will take charge of the contributions and invest them in annuities. Needless to say, the subject is an extremely sophisticated one, and an employer's choice of funding methods will depend upon a host of factors.<sup>18</sup> Methods of funding particularly applicable to the self-employed person will be considered in a later section of this article.<sup>19</sup>

A qualified pension plan has the advantage of providing the beneficiary with definite, known benefits, actuarially determined, to be paid in full upon retirement, or, in the alternative, definite contributions toward a fund which will furnish the beneficiary periodic benefits upon retirement. Since the size of the contribution to be made is not determined by the extent of the employer's profits, there is an advantage to the beneficiaries in that ordinarily they will know the size of the projected retirement benefit while they are working, and can plan accordingly. For these and cognate reasons most large businesses have some form of pension plan.

The major disadvantage to a pension plan is from the employer's point of view—he may not want to be obligated to make contributions to a plan in years when he has suffered an operating loss or made only a small profit. The alternative solution is to set up a qualified profit-sharing plan, where

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16. See PRENTICE HALL, *PENSION AND PROFIT SHARING* § 5019 (1962).

17. *Ibid.*

18. See generally *id.* §§ 1511-1766.

19. See *infra* notes 238-55 and accompanying text.

contributions are made only when the employer has a profit for the taxable years. Conversely, the disadvantage of a profit-sharing plan is often from the employee's point of view—because contributions are dependent upon profits, the ultimate available benefits cannot be determined in advance of retirement. In addition, the size of the benefits may or may not be as large as those available under a pension plan. For these reasons the profit sharing plan has obvious attractions for the small closely held business.

As previously stated, contributions to a qualified plan bring forth a variety of tax benefits. The employer is permitted an immediate deduction for his contributions to the qualified plan within the limits of the Code.<sup>20</sup> The limit of contributions to a qualified pension plan is 5% of compensation paid to covered employees, plus the sum necessary to cover past and current service costs determined actuarially, or the normal cost of the plan determined under Treasury Regulations plus 10% of past service costs. For contributions to a profit-sharing plan, an amount not in excess of 15% of the compensation paid to covered employees may be deducted by the employer. If two or more qualified plans provide benefits for the same group of employees, an overall limit of 25% of compensation paid is placed upon the allowable deduction. The employee pays no income tax on contributions for his benefit until he receives distributions under the plan.<sup>21</sup> The income from a trust set up under a qualified plan enjoys a tax exempt status during the trust's duration.<sup>22</sup>

If the employee receives a lump sum distribution upon retirement, the amount is given capital gains treatment.<sup>23</sup> Distributions from a qualified plan may also qualify for a \$5,000 death benefit income tax exclusion,<sup>24</sup> and an estate and gift tax exemption.<sup>25</sup> The plan may provide for a postponement of vesting until retirement, provided that this does not produce prohibited discrimination, but vesting of benefits is required upon termination of the plan.<sup>26</sup>

To qualify for the tax favored status a plan must be for the exclusive benefit of "employees,"<sup>27</sup> be in writing,<sup>28</sup> meet certain tests on coverage of

20. I.R.C., § 404 defines the limits on contributions by an employer to a qualified plan.

21. I.R.C., § 72(d)(1).

22. I.R.C., § 501(a).

23. I.R.C., § 402(a)(2).

24. I.R.C., § 101(b)(2).

25. I.R.C., §§ 2039(c), 2517(a).

26. I.R.C., § 401(a)(7). Added in 1962, *see infra*, note 236.

27. I.R.C., § 401(a).

28. Treas. Reg. § 1.401-1(a)(2) (1958).

eligible employees,<sup>29</sup> and not discriminate in favor of officers, stockholders, supervisors, or highly compensated employees.<sup>30</sup> It is not required, however, that all employees be covered; the plan may be limited to salaried or clerical employees.<sup>31</sup> In the case of qualified pension or profit sharing plans, a carry forward of excess contributions made currently is provided to permit their deduction in future taxable years.<sup>32</sup> A definite formula requirement for contributions to be made under a qualified profit-sharing plan was dropped by the Treasury Department in 1956<sup>33</sup> after it lost several cases on the point.<sup>34</sup>

Certain transactions between the employer and a qualified-plan trust are regulated by the Code. The employer can borrow money from the trust only when adequate security and a reasonable rate of return are provided.<sup>35</sup> Likewise, he may buy from or sell property to the trust only for adequate consideration.<sup>36</sup> Finally, any fee charge for services rendered to the trust by the employer must be reasonable.<sup>37</sup>

These, then, are the basic outlines of the deferred compensation chapters of the pre-1962 Internal Revenue Code. The problem for the self-employed individual was simply of finding a way by which he might avail himself of such plans.

### III. PROBLEMS WITH "INDIRECT" METHODS OF ESTABLISHING EQUALITY

#### A. *Morrissey-Kintner Type Professional Association*

As could be expected, the self-employed group soon set about to find methods of qualifying under the Internal Revenue Code. To accomplish this, at least without the aid of direct Congressional action, it was necessary to achieve the status of an "employee." As previously mentioned, the difficulties involved here were that partners were not considered "employees" of a partnership,<sup>38</sup> and that most states prohibited professional people from incorporating.

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29. I.R.C., §§ 401(a)(3)(A), (B).

30. I.R.C., § 401(a)(4).

31. I.R.C., § 401(a)(5).

32. I.R.C., §§ 404(a)(1)(D), (3)(A).

33. T.D. 6189, 56 Cum. Bull. 972 (1956).

34. *McClintock-Turnkey Co. v. Commissioner*, 219 F.2d 329 (9th Cir. 1954); *Produce Reporter Co. v. Commissioner*, 207 F. 586 (7th Cir. 1953); *Lincoln Elec. Co. v. Commissioner*, 190 F.2d 326 (6th Cir. 1951); *E. R. Wagner Mfg. Co.*, 18 T.C. 657 (1952).

35. I.R.C., § 503(c)(1).

36. I.R.C., §§ 503(c)(4), (5).

37. I.R.C., § 503(c)(2).

38. Revenue Rulings cited note 11 *supra*.



The first open door was found in the Internal Revenue Code's definition of those organizations which were to be taxed as a corporation. The Code states that "the term 'corporation' includes *associations*, joint-stock companies, and insurance companies."<sup>39</sup> The term "association" itself is not defined in the Code. The same Code section says that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization . . . which is not . . . a trust or estate or corporation."<sup>40</sup>

Prior to 1935, the Commissioner contended, in construing this section, that a business organization possessing characteristics of a corporation, which in fact was not incorporated, should be considered an association (and hence taxed as a corporation) even though it would be a partnership or trust under the applicable state law. In 1935 the Supreme Court accepted this contention in the *Morrissey* case,<sup>41</sup> and held that the "trust" which was organized and operated for the purpose of subdividing and selling real estate was taxable as a corporation. The Court pointed out that this particular "trust" had more of the attributes of a corporation than of an ordinary trust, *e.g.*, associates, carrying on of a business, centralized control, limited liability, continuity of life, and transferability of interests.

In the now famous *Kintner* case,<sup>42</sup> the taxpayer and a group of doctors, with *Morrissey* and several subsequent cases in mind, and knowing that a corporation could not be formed for the practice of medicine in the State of Montana, organized the Western Montana Clinic Association. It was their intent that the Association, without actually being incorporated, should have to the extent permissible by law all the attributes of a corporation, and should be treated as a corporation for federal tax purposes. With this foundation, it was contended that the Association's retirement plan qualified under the Code. The Commissioner, characteristically, took the opposite viewpoint.

In addition to other features, the Association possessed the following attributes: (1) all of the members were to be *employed* by the Association despite their ownership of beneficial interests in the Association; (2) the Association employed the services of certain non-member doctors; (3) the Association acquired all of the assets and liabilities of the former partner-

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39. I.R.C., § 7701(a)(3).

40. I.R.C., § 7701(a)(2).

41. *Morrissey v. Commissioner*, 296 U.S. 344 (1935). See also *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936).

42. *Kintner v. United States*, 107 F. Supp. 976 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954). For a similar more recent case, see *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

ship; (4) all of the property was held in the name of the Association; (5) a centralized management was established; (6) the Association was to continue until the death of the last of the original members; (7) the beneficial interest of the members had limited transferability; and (8) only the individual member was to be held liable to third parties for professional misconduct.

After studying the definitions of "associations" and "partnerships" set forth in the Treasury Regulations, the Federal District Court for the District of Montana concluded that the Western Montana Clinic Association was indeed an "association," taxable as a corporation. The court then summarized the features, as laid down by the Supreme Court in the *Morrissey* case, that were characteristic of corporations:

1. A corporation, as an entity, holds the title to the property embarked in the corporate undertaking.
2. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation.
3. The enterprise is secure from termination or interruption by the death or withdrawal of owners of participating interests.
4. Corporate organization facilitates the transfer of beneficial interests without affecting the continuity of enterprise.
5. The corporation organization permits the limitation of personal liability of participants to the property embarked in the undertaking.<sup>43</sup>

The court also interpreted *Morrissey* and subsequent court of appeals cases interpreting *Morrissey* as holding that an organization need not meet all five of the above suggested tests, but rather that the organization must be closely examined to ascertain whether it more closely resembles a corporation than a partnership, and its status is to be determined by the "balance of resemblance." The Association in question was found to meet the first, second and third of the above tests. With respect to test four, while the Association did not fully resemble a corporation, neither did it resemble a partnership. As to test five, it was held that the Association more closely resembled a partnership than a corporation. Thus, as between a corporation and a partnership, the Association was held to resemble more closely a corporation. Since, generally speaking, a partnership does not survive the death or withdrawal of a member, test three was the most

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43. 107 F. Supp. at 979.

decisive in the eyes of the court. It should be noted that this represents something of a qualitative rather than a strict quantitative approach.

The issue as to whether the taxpayer was an "employee" of the Association was resolved in his favor. The court pointed out that the doctor's time was commanded by the Association; that he was paid by the Association rather than by the patients; that his office hours and vacations were dictated by the Association; and that he could be discharged from membership in and employment by the Association. The court thus held that the pension plan involved qualified under the appropriate provision of the Internal Revenue Code.

The district court decision was affirmed on appeal,<sup>44</sup> although it is difficult to determine whether the court of appeals based its decision upon exactly the same criteria. The lower court seemed particularly impressed by the fact that the existence of the Association was not terminated or interrupted by the death or withdrawal of members. The court of appeals specifically mentioned that the district court had placed considerable emphasis on this fact, but added no approving or disapproving comment of its own. The fact that such mention was made without disapproval, however, would seem to indicate a general approval. If so, then the "qualitative" test would seem to be the prevailing case-law.

The Government argued that since physicians could not incorporate under Montana law, the Association could not be treated as a corporation for federal tax purposes. The court of appeals rejected this argument, and held that since the Association had more of the criteria of a corporation than a partnership the state classification could be disregarded for federal taxation purposes.

The Revenue Service at first elected not to follow the decision, and ruled that doctors who organize an association in order to establish a qualified pension and profit-sharing plan would be treated as partners.<sup>45</sup> However, a later Revenue Ruling held that such an organization could constitute an association, and hence qualify its pension and profit-sharing plans, if it possessed the necessary attributes.<sup>46</sup> What the necessary attributes were was not stated; regulations on the matter were to be published at

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

45. Rev. Rul. 56-23, 1956-1 Cum. Bull. 598.

46. Rev. Rul. 57-546, 1957-2 Cum. Bull. 886.

a later date. These Regulations—the so-called “Kintner” Regulations—were subsequently issued on November 15, 1960.<sup>47</sup>

### 1. Governing Law

The first significant matter covered by the “Kintner” Regulations is the effect of local law upon classification of organizations for federal tax purposes. The former regulations<sup>48</sup> provided that for the purpose of federal taxation the Internal Revenue Code made its own classification and prescribed its own standards of classification, and that local law was of no importance in this determination. The new Regulations,<sup>49</sup> on the other hand, provide that although the Internal Revenue Code rather than local law will govern the tests or standards which will be applied in determining the classification of an organization, local law will govern in determining whether the legal relationships which have been established are such that the Code’s standards are met.

### 2. Associations Characterized

The “Kintner” Regulations provide that the term “association” refers to an organization whose characteristics require it to be classified for tax purposes as a corporation rather than as another type of business organization.<sup>50</sup> To define the matter further, there is provided a list of major characteristics ordinarily found in a pure corporation, which, taken together, distinguish it from other organizations. These are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. All of the characteristics listed must be taken into account when classifying an organization. An organization will be treated as an association if the corporate characteristics are such that the organization more clearly resembles a corporation than a partnership or trust.

The resulting problem is in determining whether a particular organization more clearly resembles a corporation than a partnership or trust. The Regulations take the position that an unincorporated organization shall

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47. Treas. Reg. §§ 301.7701-1 to -11 (1960). For a general discussion of these requirements see Zarky, *Unincorporated Organizations Taxable as Corporations*, 1961 So. CAL. TAX INST. 277; 75 HARV. L. REV. 776 (1962).

48. Treas. Reg. § 39.3797-1 (1955).

49. Treas. Reg. § 301.7701-1(c) (1960).

50. Treas. Reg. § 301.7701-2(a) (1) (1960).

not be classified as an association unless such organization has more corporate characteristics than noncorporate ones.<sup>51</sup> However, in determining whether an organization has more corporate characteristics than noncorporate ones, those characteristics that are common to corporations, trusts and partnerships shall not be considered.<sup>52</sup> For example, since (1) associates, and (2) an objective to carry on business and divide the gains therefrom, are characteristics generally common to both corporations and partnerships, they will be excluded from consideration when determining whether an organization which has such characteristics is to be treated for tax purposes as a partnership or an association. Hence, the presence or absence of a *majority* of the four remaining corporate characteristics—(3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interests—will be controlling.<sup>53</sup> For this reason, these four characteristics will be accorded extended treatment in following sections.

It appears that the Regulations have taken a quantitative rather than a qualitative approach in determining whether an organization is an association.<sup>54</sup> No specific weight is given to any one of the characteristics set forth by the Regulations; the mere presence or absence of a majority is apparently to be conclusive. On the other hand, in the *Kintner* case the district court and arguably the court of appeals gave additional weight to continuity of life. As of this date, there is no case resolving the apparent inconsistency between the case law and the Regulations.

### 3. Continuity of Life

The Regulations provide that an organization will not have continuity of life for federal taxation purposes if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization.<sup>55</sup> Also, if the retirement, death or insanity of a general partner in a limited partnership results in dissolution, continuity of life does not exist unless the remaining general partners agree to continue the partnership.

It should be noted that "continuity of life" is somewhat less than a meaningful term for purposes of this discussion. The fact that an organiza-

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51. Treas. Reg. § 301.7701-2(a)(3) (1960).

52. *Ibid.*

53. Examples of the application of these rules may be found in Treas. Reg. § 301.7701-2(g) (1960).

54. See Treas. Reg. § 301.7701-2(a)(3) (1960).

55. Treas. Reg. § 301.7701-2(b)(1) (1960).

tion continues after the death of a member will not of itself meet the requirement of the Regulations. The Regulations find "continuity of life" only where there is an absence of dissolution.<sup>56</sup> A more appropriate characterization would have been the requirement of "non-dissolution." The Regulations provide that the dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law.<sup>57</sup> For example, a partnership agreement may provide that the business will be continued by the remaining members after the death or withdrawal of any member, but such an agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life under local law and consequently for purposes of federal taxation, even though the business is continued by the remaining partners.<sup>58</sup>

The Regulations do take into consideration an agreement providing that the organization is to continue for a stated period or until the completion of a stated undertaking, in determining status for tax purposes.<sup>59</sup> Continuity of life does not exist, however, if such an agreement provides for termination of the organization at will or otherwise.

A rather serious question presents itself at this point. What will be the effect of local statutes which give each member of the organization a power to terminate regardless of his prior agreement, or which provide for dissolution upon the happening of certain events. The Regulations clearly answer this question by providing that if, notwithstanding a prior agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life.<sup>60</sup> Consequently, a general partnership formed under a statute corresponding to the Uniform Partnership Act<sup>61</sup> and a limited partnership created under the Uniform Limited Partnership Act<sup>62</sup> both lack continuity of life.

Again the position taken by the Regulations appears to be contrary to that taken in the *Kintner* case. Montana adopted the Uniform Partnership Act in 1947,<sup>63</sup> before the Western Montana Clinic Association was formed. It appears that the Association was a partnership under Montana law.

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56. Treas. Reg. §§ 301.7701-2(b)(1), (2) (1960).

57. Treas. Reg. § 301.7701-2(b)(2) (1960).

58. Treas. Reg. § 301.7701-2(b)(1) (1960).

59. Treas. Reg. § 301.7701-2(b)(3) (1960).

60. *Ibid.*

61. UNIFORM PARTNERSHIP ACT §§ 31, 32.

62. UNIFORM LIMITED PARTNERSHIP ACT § 9(1).

63. MONT. REV. CODES ANN. §§ 63-101 to -515 (1947).

Nevertheless, the court which decided the *Kintner* case in 1952 found continuity of life existing because of the contractual arrangement among the partners allowing the organization to continue notwithstanding death or retirement of any of them. Hence, under the "Kintner" Regulations, the Western Montana Clinic Association would lack continuity of life—a rather anomalous situation.

#### 4. Centralization of Management

As distinguished from a partnership, the management of a corporation is usually vested in a board of directors or some similar body. In general, all members of a partnership, by the nature of the organization, have an interest in the management of the business (providing there is no contrary agreement).<sup>64</sup> The Regulations provide that an organization has a centralized management if any person or any group of persons which does not include all the members has continuing exclusive authority to make the management decisions necessary for conduct of the business for which the organization was formed.<sup>65</sup> The Regulations further provide that the persons who have such authority may, or may not, be members of the organization, and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office.<sup>66</sup> However, there is no centralized management when the centralized authority is merely to perform ministerial acts as an agent under the direction of a principal.<sup>67</sup>

The Regulations rule that a general partnership, subject to a statute corresponding to the Uniform Partnership Act, cannot achieve effective concentration of management powers, and, therefore, centralized management.<sup>68</sup> The basis of this ruling is the mutual agency relationship that exists between members of a general partnership created under the Uniform Partnership Act or a similar act.<sup>69</sup> Again, note the existence of a distinction that was not made in the *Kintner* case. Normally, of course, limited partnerships created under a statute corresponding to the Uniform Limited Partnership Act<sup>70</sup> do not have centralized management. But, if substantially all the interests in the limited partnership are owned by the limited partners, centralized management ordinarily does exist.

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64. UNIFORM PARTNERSHIP ACT § 18(e).

65. Treas. Reg. § 301.7701-2(c)(1) (1960).

66. Treas. Reg. § 301.7701-2(c)(2) (1960).

67. Treas. Reg. § 301.7701-2(c)(3) (1960).

68. Treas. Reg. § 301.7701-2(c)(4) (1960).

69. UNIFORM PARTNERSHIP ACT § 9(1).

70. UNIFORM LIMITED PARTNERSHIP ACT § 9(1).

### 5. Limited Liability

Under the "Kintner" Regulations, an organization is deemed to have the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization.<sup>71</sup> It is permissible for a member of an organization to make an agreement whereby another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for his liability. However, if under local law the member remains liable to the organization's creditors, he is deemed to have personal liability. Consequently, personal liability exists with respect to each general partner of a general partnership under a statute corresponding to the Uniform Partnership Act.<sup>72</sup> Likewise, in the case of a limited partnership under statute corresponding to the Uniform Limited Partnership Act,<sup>73</sup> personal liability exists with respect to each general partner except (1) with respect to each general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization, and (2) when he is merely a "dummy" acting as agent for the limited partners, in which case personal liability will exist with respect to such limited partners regardless of the limited partnership.<sup>74</sup>

### 6. Free Transferability of Interests

The Regulations deem an organization to have the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization can, without the consent of other members, substitute for themselves in the organization a person who was previously not a member of the organization.<sup>75</sup> For this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his successor all the attributes of his interest in the organization. Thus, even though an agreement provides otherwise, there is no power of substitution and no free transferability of interest for tax purposes if under local law the transfer of a member's interest results in the dissolution of the old organization and the formation of a new one. Statutes corresponding to the

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71. Treas. Reg. § 301.7701-2(d)(1) (1960).

72. UNIFORM PARTNERSHIP ACT § 15.

73. UNIFORM LIMITED PARTNERSHIP ACT § 9(1).

74. Treas. Reg. §§ 301.7701-2(d)(1), (2) (1960).

75. Treas. Reg. § 301.7701-2(e)(1) (1960).



Uniform Partnership Act<sup>76</sup> provide that the conveyance by a partner of his interest in the partnership does not of itself, in the absence of an agreement, entitle the assignee, during the continuance of the partnership, to participate in the management or administration of the partnership business or affairs. Nor may any person become a member of a partnership without the consent of all the partners.<sup>77</sup> Accordingly, an organization created under such a statute would clearly seem to violate the Regulation's requirement.<sup>78</sup> On the other hand, the interest of a limited partner, under the Uniform Limited Partnership Act, is clearly assignable.<sup>79</sup> Consequently, if the limited partners own substantially all of the interests of the limited partnership, free transferability of interests will be deemed to exist.

The Regulations do recognize a modified form of free transferability of interest.<sup>80</sup> This is deemed to exist when there is an agreement allowing a member to transfer his interest to an outsider after the other members have refused to purchase the interest at fair market value. However, in determining classifications of organizations, this modified characteristic will be accorded less significance than if such characteristic were present in an unmodified form.<sup>81</sup>

## 7. Illustrations

The Regulations contain several illustrations wherein the basic criteria are applied to hypothetical organizations. Reference to these is helpful in understanding the requirements for a qualified plan. One such example is as follows:

A group of twenty-five persons forms an organization for the purpose of engaging in real estate investment activities. Under their agreement, the organization is to have a life of twenty years, and under the applicable local law, no member has the power to dissolve the organization prior to the expiration of that period. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of the committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has

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76. UNIFORM PARTNERSHIP ACT § 27(1).

77. UNIFORM PARTNERSHIP ACT § 18(g).

78. Treas. Reg. § 301.7701-2(c)(1) (1960).

79. UNIFORM LIMITED PARTNERSHIP ACT § 19(1).

80. Treas. Reg. § 301.7701-2(e)(2) (1960).

81. *Ibid.*

the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the corporate characteristic of limited liability, it does have continuity of life, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.<sup>82</sup>

It would appear from the foregoing that, in the absence of specific legislation, any organization otherwise governed by the Uniform Partnership Act could not possibly qualify as an "association." The fact that a majority of the states<sup>83</sup> have adopted the Uniform Partnership Act would thus seem to make the Kintner-type association a rather rocky path to the benefits of a qualified deferred compensation plan.

The brighter side of the picture is the possibility that the courts may refuse to follow the Regulations. The court which decided the *Kintner* case had no difficulty in ascribing "association" status to the Western Montana Clinic Association. As was pointed out earlier, the Western Montana Clinic Association would probably not meet the requirements of the "Kintner" Regulations. If and when such a case does reach the Supreme Court, the Court may well decide that the view adopted by the court in the *Kintner* case is the correct interpretation of the Code. Another bright spot is the recent announcement that the Commissioner is considering amending the "Kintner" Regulations.

Even if the *Kintner* case is followed, however, it is questionable as to how beneficial this type of "association" will be in some of the other professions. For example, the legal profession may not be readily adaptable to the clinic-type organization, because of the highly personal nature of the attorney-client relationship. It is true, of course, that others may yet devise an organization pattern that will qualify under the case-law or Regulations and still prove suitable for other types of professions.<sup>84</sup> On the whole,

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82. Treas. Reg. § 301.7701-2(g)(5) (1960).

83. As of the date of this printing, forty states and the District of Columbia have adopted the Uniform Partnership Act. Missouri is among those states. See c. 358, RSMo 1959.

84. The foregoing discussion is based upon the Treasury Regulations as they now stand. If the Commissioner alters them with the passage of H.R. 10, this area will have to be re-examined in light of those changes.

however, for many professionals there may be no alternative other than actual incorporation—a matter of no little complexity and difficulty in and of itself.

## B. Professional Corporations

### 1. The Need for Professional Incorporation

The “Kintner” Regulations, quite obviously, have made the professional “association” scheme a rather questionable way of attempting to achieve deferred compensation tax benefits. Even though a court might indeed hold the Regulations invalid, most professionals are unwilling to risk such a contingency. In view of that fact, and in view of the fact that H.R. 10 (to be considered in a later section of this article) is of somewhat dubious value, many professional men, including those who have made it their business to devote careful study to this field, still consider that professional corporations are badly needed to remedy the inequality that now exists with regard to deferred compensation taxation.

The pressure upon states to allow professional corporations began shortly after the promulgation of the “Kintner” Regulations. The problem was somewhat analogous to that in which the states found themselves several years ago with regard to community property, before Congress enacted the income, gift, and estate-splitting provisions of the present Internal Revenue Code. The argument made by professionals, similar in theory to that advanced as to community property, was that if states did not change their laws to allow professional corporations, they would deny to their citizens tax advantages available in other states which did allow professional men to incorporate.

The result has been an unwilling swing toward allowing members of certain professional groups to incorporate or qualify as an association.<sup>85</sup>

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85. For general background material see *Panel: Professional Associations*, 101 TRUSTS & ESTATES 886 (1962); *Panel: Professional Associations: Substance, Ethics, and Taxation*, 1962 A.B.A. SECT. REAL PROP. L. 25 (1962); *Symposium: Professional Associations*, 13 W. RES. L. REV. 195 (1962); Baker and Hudson, *Professional Association—A New Legal Entity*, 23 ALA. LAW. 134 (1962); Beinfeld, *Advantages and Factors in Forming a Professional Association*, 50 ILL. B. J. 904 (1962); Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961); Buchmann & Bearden, *Professional Service Corporations—A New Business Entity*, 16 U. MIAMI L. REV. 1 (1961); Bye & Young, *Law Firm Incorporation in Colorado*, 34 ROCKY MT. L. REV. 427 (1962); Dunkel, *Professional Corporations*, 22 OHIO ST. L. J. 703 (1961); Eber, *Professional Service Corporations—The Answer to the Kintner-type Organization*, 100 TRUSTS & ESTATES 758 (1961); Eber, *Pros and Cons of the New Professional Service Corporations*, 15 J. TAXATION 308 (1961); Fleig, *Professional Corporations*, 33

By 1962, fourteen states had adopted various types of acts allowing professional associations or corporations.<sup>86</sup> Others are accomplishing the same

OKLA. B.A.J. 357 (1962); Freutel & Frost, *Why Lawyers Should Have the Right to Practice in Corporate Form*, 37 CALIF. S.B.J. 874 (1962); Frost, *Some Comments as to Professional Corporation Statutes*, 4 ARIZ. L. REV. 169 (1963); Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individuals Tax Retirement Act of 1962 and the Professional Association*, 63 COLUM. L. REV. 415 (1963); Grayck, *Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comment*, 17 TAX L. REV. 469 (1962); Haynes, *Professional Association Pension Plans*, 5 So. TEX. L.J. 354 (1961); Jones, *Should Lawyers Incorporate?*, 11 HASTINGS L.J. 150 (1959); Jones, *Professional Corporation*, 27 FORD L. REV. 353 (1958); Lyon, *Corporate Practice of Law—Problems and Advantages*, 3 L. OFF. ECON. & MAN. 21 (1962); Lyons, *Comments on the New Regulations on Associations*, 16 TAX L. REV. 441 (1961); 26 ALBANY L. REV. 246 (1962); Mackey, *Professional Associations Instead of Partnerships*, 107 TUL. TAX INST. 409 (1961); Maier & Wild, *Taxation of Professional Firms as Corporations*, 44 MARQ. L. REV. 127 (1960); Maier, *Professional Corporations and the Kintner Association Advancing: Box Score to Date*, 17 J. TAXATION 2 (1962); Maier, *Don't Confuse Kintner-type Associations with New Professional Corporations*, 15 J. TAXATION 248 (1961); Marcus, *Why Lawyers Should Not Be Permitted to Practice in Corporate Form*, 37 CALIF. S.B.J. 898 (1962); Mow, *Professional Associations and Professional Corporations*, 16 SW. L.J. 462 (1962); Nolan, *Tumult in the Industry—Corporate Tax Status for the Professional*, 14 J. AM. SOC. C.L.U. 217 (1960); Ohl, *Corporate Tax Status for Lawyers*, 33 N.Y.S.B.J. 165 (1961); Porter, *Associations of Attorneys Taxable as Corporations*, 30 J.B.A. KAN. 235 (1962); Ray, *Corporate Tax Treatment of Medical Clinics Organized as Associations*, 39 TAXES 73 (1961); Sarner, *Associations Taxable as Corporations: A Review and a Look Ahead*, 20 N.Y.U. INST. FED. TAXATION 609 (1962); Specter, *Pension and Profit Sharing Plans: Coverage and Operation for Closely Held Corporations and Professional Association*, 7 VILL. L. REV. 335 (1962); Stavole, *Corporate Employee Tax Status for the Professional Man*, 11 CLEV. MAR. L. REV. 176 (1962); Stutsman, *How to Transfer a Professional Partnership into a Kintner Association*, 11 J. TAXATION 336 (1959); Waisel, *Tax Aspects of a Professional Association*, 3 L. OFF. ECON. & MAN. 137 (1962); White & Peterson, *Corporate Tax Advantages for Attorneys*, 35 CALIF. S.B.J. 167 (1960); Williams & Cowart, *Federal Income Tax Advantages for Professionals—The Georgia Professional Association Act*, 12 MERCER L. REV. 388 (1961); Wilson, *Professional Associations Taxable as Corporations*, 5 TEX. INST. 1 (1961); Wolper, *Medical Entities Taxed as Corporations: A New Field*, 15 J. AM. SOC. C.L.U. 353 (1961); 1 B.C. INC. & COM. L.R. 260 (1960); 107 B.U. L. REV. 43 (1963); 36 FLA. B.J. 16 (1962); 75 HARV. L. REV. 776 (1962); 37 IND. L. J. 124, 138 (1961); 47 MASS. L. Q. 405 (1962); 37 NOTRE DAME LAW. 545 (1962); 34 ST. JOHN'S L. REV. 372 (1960); 35 TEMP. L.J. 312 (1962); 29 TENN. L. REV. 437 (1962); 31 U. CINC. L. REV. 341 (1962); 64 W. VA. L. REV. 310 (1962). For treatments of particular statutes, see, among others, Bye & Young, *supra*; Horsley, *Virginia Professional Association Act: Relief for the Underprivileged?*, 48 VA. L. REV. 777 (1962); Kahn, *The Wisconsin Service Corporation Law of 1961*, 1962 WIS. L. REV. 65 (1962); Linquist & Mulhern, *Professional Association in Illinois: Fringe Benefits for Members of the Professions*, 50 ILL. B.J. 98 (1961); Maier, *Use of the New Wisconsin Service Corporation Law*, 22 GAVEL 11 (1962); Morrison, *The Proposed Professional Corporation Law of Missouri*, 19 J. MO. BAR 228 (1963); Ohl, *Corporate Practice of Law in New York*, 40 TAXES 263 (1962); Thrower and Cohen, *Professional Associations under Georgia Act—Some Tax Aspects and Considerations of Legal Ethics*, 24 GA. B.J. 163 (1961); Williams & Cowart, *supra*; Williams, *Medical and Dental Corporations: A Step Towards Tax Equality*, 15 ARK. L. REV. 366 (1962); 14 ALA. L. REV. 79 (1961); 31 U. CINC. L. REV. 71 (1962); 37 NW. L. REV. 334 (1962).

result, at least as to lawyers, by court rule.<sup>87</sup> Even the American Bar Association Committee on Professional Ethics has given its endorsement, although not without reservation.<sup>88</sup>

Seven states authorize professional "corporations" which are to be governed under the state's general business corporation statutes except for some restrictions imposed with regard to a professional "corporation's" special character.<sup>89</sup> Eight states have attempted to confer corporate characteristics either by creating a new entity termed an "Association" for rendering professional services, or by amending their partnership law to enable members of professional firms to make private agreements adopting corporate characteristics.<sup>90</sup> One of these states calls such an organization both a "corporation" and an "association."<sup>91</sup> At least two state Supreme Courts have given their approval to such statutes as regards attorneys;<sup>92</sup> one has in effect ruled the statute inapplicable to attorneys, regardless of legislative intent.<sup>93</sup>

Because enabling statutes and court rules are drafted to meet ethical objections to professional incorporation, and to assure that individual professional shareholders will still be subject to professional discipline, the professional corporation will be a *rara avis* in the corporate sphere. Most professional groups will continue to operate as partnerships for all practical

86. Alabama Professional Association Act, 2 P-H CORP. SERV. Ala. 221 (1961); Arkansas Medical and Dental Corporation Acts, ARK. STAT. §§ 64-1701-17, -1801-17 (Supp. 1961); Connecticut Uniform Partnership Act, Conn. Pub. Acts 1961, No. 158, § 44 (all professions) and No. 394 (physicians); Florida Professional Service Corporation Act, Fla. Laws 1961, c. 61-64 (Supp. No. 2, 1961); Georgia Professional Association Act, GA. CODE ANN. §§ 84-4301-18 (Supp. 1961); Illinois Act To Authorize Professional Associations, ILL. ANN. STAT. c. 106½, §§ 101-09 (Smith-Hurd Supp. No. 6, 1961); Minnesota Professional Corporation Act, Minn. Laws 1961 (Extra Session), c. 1 (Supp. No. 6, 1961) (physicians); OHIO REV. CODE ANN. §§ 1785.01-08 (Baldwin Supp. 1961); Oklahoma Professional Corporation Act, OKLA. STAT. ANN. tit. 18, §§ 801-19 (Supp. No. 7, 1961); Pennsylvania Professional Association Act, Pa. Laws 1961, No. 416 (Supp. No. 7, 1961); South Dakota Medical Corporation Act, S.D. Laws 1961, c. 29; Tennessee Uniform Partnership Act, TENN. CODE ANN. § 61-105 (Supp. 1961); Texas Laws 1961, c. 158, § 6(3) (Supp. No. 3, 1961); Wisconsin Service Corporation Law, Wis. Laws 1961, c. 350 (Supp. No. 5, 1961).

87. See COLO. SUP. CT. R. 231.

88. Opinion No. 303, 48 A.B.A.J. 159 (1962).

89. Arkansas, Colorado, Florida, Minnesota, Oklahoma, South Dakota and Wisconsin.

90. Alabama, Connecticut, Georgia, Illinois, Ohio, Pennsylvania, Tennessee and Texas.

91. Ohio.

92. In the Matter of the Florida Bar, 133 So.2d 554 (Fla. 1961); COLO. SUP. CT. R. 231.

93. State *ex rel.* Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962), 31 U. CINC. L. REV. 341 (1962), 14 SYRACUSE L. REV. 104 (1962).

purposes. Stock ownership in such a corporation will have less significance than in other service corporations, for the professional man's share of the corporate income will be essentially contingent upon his actual contribution to the production of that income, not upon mere ownership of stock. Corporate assets will not be substantial since the personal capabilities of the shareholders and other employees will constitute the primary income producing assets of the corporation, rather than tangible assets. Therefore, the intrinsic value of a share of stock in such a corporation belonging to a deceased or retired member will be relatively small. It is further obvious that a group of professionals will be reluctant to admit anyone to their firm ("corporation") who lacks the unanimous approval of the present members, just as they would have been when practicing under a partnership agreement.

As will be seen later, these restrictions may prove bothersome to a professional corporation seeking to make an election to be taxed as a partnership under Subchapter S. Such points, however, raise an even more fundamental problem: will the Commissioner accept a firm doing business under such a statute as a bona fide corporation for purposes of the federal tax law?

## 2. Validity of Professional Incorporation Statutes for Federal Tax Purposes

Any discussion of the tax problems which will be encountered by the professional man operating under an incorporation statute must start with the question of the statute's validity—validity not in the sense of whether state legislatures can authorize professional practice in such a form, but instead whether these organizations, regardless of what a state may call them, should be classified as "associations" or "corporations" within the meaning of the Internal Revenue Code.<sup>94</sup> At least one writer, Professor Bittker,<sup>95</sup> has expressed severe doubts on the matter, and has argued most persuasively that because the new statutes "impose restrictions on the professional corporation that are not applicable to typical business corporations,"<sup>96</sup> as well as for additional policy reasons, they should not be granted the desired tax consequences which led to their adoption.

Bittker first notes that organizations formed under such statutes face

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94. See Comment, 75 HARV. L. REV. 776 (1962).

95. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

96. *Id.* at 3.

attack from the Commissioner on several fronts, quite apart from their qualification under Code section 7701(a)(3): (1) the assignment of income doctrine,<sup>97</sup> (2) the sham transaction theory,<sup>98</sup> (3) the theory of professional persons as "independent contractors,"<sup>99</sup> and (4) the personal holding company tax.<sup>100</sup> The basic problem, however, is whether the new organizations really possess the required majority of the four characteristics required by the "Kintner" Regulations, *i.e.*, limited liability, centralization of management, continuity of life, and free transferability of interests.<sup>101</sup>

Most of the statutes in question have been carefully drafted to preserve "intact the entire congeries of relationships between an individual practitioner and his patients and clients."<sup>102</sup> Thus it can be argued that a professional association or corporation under such a statute will still constitute a mutual agency relationship, with mutual liability existing among the members as in the case of a partnership.<sup>103</sup> The difficulty in meeting the Commissioner's requirement of limited liability is therefore obvious. Furthermore, the personal responsibility of a lawyer or physician is so vital to the whole purpose of the organization that it is questionable whether there can be any centralization of management in the sense required by the Regulations. Each practitioner could presumably bind the organization by his individual decision as to treatment or course of litigation to be followed, risks to be assumed, etc.—decisions fundamental to the organization's purpose—in the same manner as in a partnership. As to continuity of life, although the statutes purport to confer it, normally the organization can avoid dissolution only by re-purchasing the shares of a disqualified member. Thus, any member's disqualification from practice, election to public office, death, bankruptcy or retirement might well imperil the organization's life, since funds for the repurchase of a member's stock may not be available at a critical time, or the organization may be forbidden by state law to use its funds for such a purpose. Finally, free transferability of interest for professional groups, argues Bittker, is nothing short of ludicrous, regardless of the words utilized in the various statutes.<sup>104</sup> Even if the or-

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97. See *Lucas v. Earl*, 281 U. S. 111 (1930).

98. See *Commissioner v. Laughton*, 113 F.2d 103 (9th Cir. 1940). See also *Mayes v. United States*, 207 F.2d 326 (10th Cir. 1953); *W. B. Mayes, Jr.*, 21 T.C. 286 (1953).

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

100. See *infra* notes 121-26 and accompanying text.

101. *Supra* notes 56-82 and accompanying text.

102. Bittker, *supra* note 96, at 9.

103. *Ibid.*

104. *Id.* at 17.

ganization's shares can be held by individuals merely licensed in the profession, as opposed to active practitioners, such shares are certainly much less freely transferable than shares of the ordinary business corporation. Various schemes regarding repurchase of shares upon a member's death or retirement would be so likely to involve a complete reorganization of the financial and professional arrangements of the firm that they would not achieve the type of free transferability described in the Regulations. Bittker's verdict is that the professional association or corporation possesses only doubtful limited liability, a modified form of centralized management, doubtful continuity of life, and in most cases something less than a free transferability of interests.<sup>105</sup>

Bittker finds no substantial difference between the "corporation" type of statute and the "association" type of statute as far as federal tax consequences are concerned. Simply calling something a "corporation" does not necessarily make it such under the Internal Revenue Code. Bittker illustrates the proposition with the extreme example of a state which modifies a statute comparable to the Uniform Partnership Act by substituting the word "corporation" for the word "partnership" wherever the latter term appears.<sup>106</sup>

Bittker further condemns professional corporation and association acts upon a public policy basis. Although state law will often affect the federal income tax burden of its citizens, "the statutes permitting the organization of professional associations and corporations have no apparent purpose other than federal tax reduction; they alter the non-tax results of professional practice in only minimum degree; and they would have, if successful, a substantial effect on the federal revenue."<sup>107</sup> By way of contrast, Bittker argues, even the enactment of community property systems before the income-splitting provisions were written into the federal tax laws had private law consequences, especially in the field of domestic relations, justifying an exercise of the states' legitimate supervision in the area. Bittker's objection to the new statutes is that the states have done little more than apply new labels to the same relationships.

It should not be assumed, however, that Bittker's is the last word upon the subject. Professor Gryack,<sup>108</sup> in examining the same statutes, con-

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105. *Id.* at 21.

106. *Id.* at 28.

107. *Ibid.*

108. Grayck, *Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments*, 17 *TAX L. REV.* 469 (1962). Cf. Comment, 75 *HARV. L. REV.* 780-85 (1962).



cludes that the "Kintner" Regulations are indeed met. Furthermore, one should note a possible flaw in Bittker's public policy argument. While it is indeed true that, after a moment's reflection, one may discern non-tax consequences in the community property legislation of the 1940's, the question actually seems to be one of motive, and it would be naive to pretend that either professional corporation statutes or the community property statutes of the 1940's were primarily motivated by anything other than tax reasons.

How courts will eventually deal with the professional corporation for federal tax purposes still seems open to question. Perhaps the only prognosis that can be made at this stage is that a court's method of approach may well be determinative. Thus, a court following the rationale of the "Kintner" Regulations might well find Bittker's argument persuasive. On the other hand, as pointed out in a preceding section of this article, a court might well sustain a taxpayer even in face of the "Kintner" Regulations and even without benefit of an association or corporation statute. A court of this bent would undoubtedly sustain a taxpayer under a corporation or association statute as well.

### C. *Tax Traps for the Professional Corporation or Association*

Assuming that the statutes and court rules considered in the preceding sections are effective under the "Kintner" Regulations to create corporations or associations which qualify for corporate tax treatment, it becomes necessary to explore some of the tax problems which these new entities will encounter. There are five main traps which such organizations must avoid.

#### 1. Reasonableness of Withdrawals for Salaries

A common scheme employed by closely-held corporations to minimize corporate income tax is to pay out the earnings of the corporation in the form of salaries to officers and employees. Quite obviously, of course, the payment of reasonable salaries is to be expected, and the corporation can deduct "a reasonable allowance for salaries or other compensation"<sup>109</sup> from its gross income. As one might also expect, that which is "reasonable" is hard to define.<sup>110</sup> The normal rule of thumb is that the reasonableness of salaries will be measured by comparison with salaries paid by other corpora-

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109. I.R.C., § 162 (a)(1).

110. See *Klamath Medical Serv. Bureau v. Commissioner*, 261 F.2d 842 (9th Cir. 1958), *cert. denied*, 395 U.S. 966 (1959); *McClung Hospital, Inc.*, 19 T.C. 449 (1960).

tions similarly situated.<sup>111</sup> This standard may prove almost impossible to apply to professional corporations, however, inasmuch as it would be difficult to find another similar firm to serve as a standard since the ability of the particular members is the income producing asset. Furthermore, in a partnership senior partners often receive more compensation than their time devoted to any particular problem would justify. Since the taxpayer has the burden of proof as to the reasonableness of compensation,<sup>112</sup> any attempt to continue such standard partnership practices with regard to salaries may be open to attack by the Commissioner.

## 2. Accumulated Earnings

In the past, closely-held corporations have often been tempted to accumulate corporate earnings in anticipation of a stock redemption, in order that the individual shareholder will receive capital gains treatment upon the redemption of his shares. This might well be an attractive device for a professional corporation as well, were it not for the accumulated earnings provisions of the Internal Revenue Code,<sup>113</sup> which impose a tax of 27.5% on the first \$100,000 of accumulated taxable income, and 38.5% on such income over \$100,000. "Accumulated taxable income" is defined as taxable income for the year (with slight adjustments) minus: (a) a dividend paid deduction, and (b) an accumulated earnings credit.<sup>114</sup> The accumulated earnings credit, in turn, consists of a minimum lifetime credit of \$100,000 plus any part of the earnings and profits of the corporation for the taxable year that are retained for the reasonable needs of the business.<sup>115</sup> Thus, retained earnings and profits in excess of \$100,000 may be subject to attack on the ground of unreasonable accumulation. If such is shown to be the case, code section 533(b) establishes that the corporation was formed or availed of for the purpose of avoiding the income tax—the actual test for imposition of the accumulated earnings tax.<sup>116</sup>

For a small professional corporation the accumulated earnings problem will seldom arise, simply because such an organization would seldom accumulate more than \$100,000. In larger professional organizations, however, the problem may at times become acute, particularly where the organization seeks to set aside amounts for the future redemption of withdrawing mem-

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111. Treas. Reg. § 1.162-7(b)(3) (1958).

112. *Reinecke v. Spalding*, 280 U.S. 227, 232 (1930).

113. I.R.C., §§ 531-537.

114. I.R.C., § 535(a).

115. I.R.C., § 535(c).

116. I.R.C., § 532(a).

bers' shares. The difficulty here would be in convincing the Commissioner that such a redemption constitutes a legitimate business purpose.<sup>117</sup> The problem, of course, might also arise in other ways; in such a case the question of reasonableness would probably be determined in accordance with the peculiarities of the particular profession involved.<sup>118</sup> It should be noted, however, that the intelligent use of reserves for legitimate contingencies and qualified deferred compensation plans (which in reality are the primary reasons for establishing such corporations) will serve to alleviate the problem.<sup>119</sup>

### 3. The Personal Holding Company Tax

Perhaps more troublesome to the average professional corporation than the accumulated earnings tax will be the personal holding company tax.<sup>120</sup> A corporation in which 50% of the outstanding stock is owned by five or fewer persons may be subject to attack as a personal holding company if at least 80% of its gross income for the particular year is "personal holding company income" which is not distributed within that year.<sup>121</sup> For determining ownership of stock the Code in section 544 has involved constructive ownership rules which must be considered. "Personal holding company income" consists of nine rather broad categories of income, notable among which, as concerns the professional corporation, are amounts received under personal service contracts.<sup>122</sup> This provision of the Code applies whenever some person other than the corporation (*i.e.*, the client) has the right to designate the member of the corporation who is to perform the services, if the member so designated owned, during the taxable year, 25% or more of the outstanding stock of the corporation.<sup>123</sup> Amounts subject to the personal holding company tax are taxed at a rate of 75% on the first \$2,000 and 85% on amounts above \$2,000.<sup>124</sup>

This area may well present something of a problem for the smaller professional organization, partly because such organizations are the ones

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117. See Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961).

118. As to what may constitute a legitimate accumulation, see Treas. Reg. §§ 1.537-1(a), -2(b) (1959).

119. See Eber, *The Pros and Cons of the New Professional Service Corporation*, 15 J. TAXATION 308, 311 (1961).

120. I.R.C., §§ 541-547.

121. I.R.C., § 542(a).

122. I.R.C., § 543(a)(5).

123. It should be noted that the stock attribution rules of § 544 may cause some problems in this area for small or family professional corporations.

124. I.R.C., § 541.

most likely to run afoul of the stock ownership requirements, and partly because when dealing with such organizations the client may more often expect to select the person who is to perform the service. With larger organizations such problems are less likely to arise. Apparently the only method of avoiding the tax other than distributing all the income would be to make sure that at least 21% of the corporate income was either the result of services performed by persons who were not designated by the client or by persons who owned less than 25% of the corporation's outstanding stock. The problem becomes particularly acute in view of the Treasury Regulations that the services provided by such persons must be "important and essential" services.<sup>125</sup> The only reasonable interpretation of this requirement is that such services must be professional services rendered by professional persons, not merely clerical or administrative work performed by secretaries or investigators.

#### 4. Stock Redemptions

A stock redemption is treated as a distribution in part or full payment in exchange for the stock redeemed, and thus qualifies for capital gains or loss treatment, *if* the redemption falls within one of four categories designated by the Code: (1) a redemption which is not essentially equivalent to a dividend; (2) a redemption which is substantially disproportionate with respect to the shareholder's stock; (3) a redemption which completely terminates the shareholder's interest; (4) and redemptions in certain railroad reorganizations.<sup>126</sup> Any stock redemption that does not fall within one of these categories is treated as a simple distribution, constituting a dividend to the extent of current and accumulated post-1913 earnings and profits, a return of capital to the extent of the adjusted basis of the stock and a gain from the sale or exchange of property to the extent of any excess.<sup>127</sup> As far as the professional corporation is concerned, of course, only the first three categories will be applicable.

Since stock redemptions are the method by which professional corporations will seek to maintain their unity, and since all of the present statutes authorizing professional corporations or associations have provided some system by which the corporation or association may redeem stock of a deceased, retired, expelled or disqualified shareholder,<sup>128</sup> the stock redemp-

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125. Treas. Reg. § 1.543-(b)(8)(ii) (1958).

126. I.R.C., §§ 302(a), (b).

127. I.R.C., § 301. See generally Bittker, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 138 (Student Ed. 1959).

128. See Bittker, *supra* note 96, at 38.

tion provisions of the Code may prove to be of some importance to such organizations. A problem for the small firm is that attribution rules<sup>129</sup> apply in determining the ownership of the stock.<sup>130</sup> Under these rules, an individual is considered as constructively owning any stock that is actually owned by certain members of his "extended" family. Thus, where the firm's shares are owned by a related group, the so-called family ownership rule may impute to each person the ownership of all the corporate stock.<sup>131</sup> This may mean that neither the "substantially disproportionate redemption" category nor the "complete termination of shareholder's interest" category will apply to a redemption of stock owned by such a person. It should be noted, however, that as to the "complete termination of interest" category the family ownership rule will not apply if: (a) immediately after the redemption the former shareholder has no interest in the corporation other than as a creditor; (b) the former shareholder does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years of such redemption; and (c) the former shareholder notifies the Commissioner of any such stock acquired by bequest or inheritance.<sup>132</sup> On the other hand, "waiver" of the family ownership rule does not apply if within 10 years preceding the redemption the distributee either acquired some of the redeemed stock from certain persons designated in the attribution rules or prior to redemption transferred any stock to such a person if such acquisition or transfer had "as one of its principal purposes the avoidance of federal income tax."<sup>133</sup> A transfer is not presumed to have been made for the purpose of tax avoidance merely because the transferee was in a lower income tax bracket than the transferor,<sup>134</sup> a situation which might easily apply to a transfer of corporate stock between a professional man and his son. On the other hand, where the purpose of the transfer was to reduce total family income taxes, this may prevent waiver of the family ownership rule.<sup>135</sup>

### 5. Income Averaging

The professional man employed by a professional corporation or association will lose the spreadback provisions now available to individuals and

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129. I.R.C., § 318(a).

130. I.R.C., § 302(c)(1).

131. See Ringo, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958).

132. I.R.C., § 302(c)(2).

133. I.R.C., § 302(c)(2)(B).

134. Treas. Reg. § 1.302-4(g).

135. See Rev. Rul. 57-387, 1957-2 Cum. Bull. 225; Rev. Rul. 56-556, 1956-2 Cum. Bull. 177; Rev. Rul. 56-584, 1956-2 Cum. Bull. 179.

members of partnerships.<sup>136</sup> These provisions, which allow income to be averaged back over the time it was earned if it was earned over a period of 36 months or more and the compensation received in one tax year is 80% or more of the total, are obviously of great value to the professional. It is questionable, therefore, whether the tax advantages to be gained from incorporation are substantial enough to outweigh this provision. The problem will be particularly pressing for professional people in certain specialized areas, *e.g.*, the lawyer who specializes in personal injury litigation.

## 6. Miscellaneous Problems

Aside from the more or less standard problems which may be expected to arise with regard to professional corporation taxation, there are several other problems of varying importance which should be taken into consideration. It should be noted, for instance, that a deferred compensation plan established by a professional corporation or association, while more advantageous tax-wise than those presently allowed under H. R. 10 (considered in a later section of this article), may often be subject to attack as discriminatory<sup>137</sup> unless care is used in their drafting. Again, the loss of flexibility inherent in a professional firm's incorporation should be taken into account. The feasibility of a centralized management for the large law firm, where a committee of senior partners perhaps already wields great power over fees, allocation of clients, salaries, hiring, etc., is one matter; centralized management for a clinic's staff of physicians or for a small law firm is quite another. Furthermore, withdrawal from a professional corporation in the event of disagreement may be difficult because of lack of any ready market for the shares, particularly in the small firm, where the corporation itself might not have the ready cash to redeem the shares of the dissident member.<sup>138</sup> While a very loose association might avoid the problems of centralized management and the dissident shareholder, such an association is much more subject to attack as lacking a fundamental corporate attribute required by the Code.

### D. *Subchapter S and the Professional Corporation*

Subchapter S was introduced into the Internal Revenue Code by the

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136. I.R.C., § 1301.

137. See I.R.C., § 401(b)(4). See generally Treas. Reg. § 4.401-4; Rev. Rul. 57-163, 1957-1 Cum. Bull. 128, parts 2(i), 5(a).

138. The proposed Missouri Professional Corporations Act, Mo. S. B. 108, 72d Gen. Ass. (1962), is silent on this point.

Technical Amendments Act of 1958,<sup>139</sup> with the avowed purpose of eliminating the consideration of federal income tax consequences in the selection of a form of business organization for small businesses.<sup>140</sup> Under these sections, a "small business corporation" is able to elect whether or not it will be taxed under the provisions of the subchapter.<sup>141</sup> Essentially a "small business corporation" is<sup>142</sup> a domestic corporation not a member of an affiliated group with one class of stock and fewer than 11 individual shareholders none of whom are nonresident aliens.<sup>143</sup> No corporate tax is paid if the election is made,<sup>144</sup> and the corporation's current taxable income is included on a per-share basis in the gross income of the shareholders.<sup>145</sup> Generally, shareholders report this as ordinary income, except for certain long-term capital gains which retain their character in the shareholder's hands.<sup>146</sup>

Subchapter S should prove particularly appealing for the professional corporation or association. Under its terms, a qualifying professional corporation or association can elect to have its current income included directly in its shareholders' gross income without intervening corporate tax,<sup>147</sup> thereby relieving such income from the spectres of accumulated earnings and personal holding company taxes. Furthermore, shareholder-employees apparently would not forfeit their qualified pension and profit-sharing plans or other fringe benefits by making such an election.<sup>148</sup> Thus, the combination of a professional corporation and an election under Subchapter S would allow employees of the corporation to gain deferred compensation benefits and at the same time relieve the corporation of most of the tax traps detailed in the previous section.

As an added inducement to a Subchapter S election, there is an income shifting feature which partly makes up for the loss of the spread-back provisions available only to individuals or partners. Any undistributed taxable income is taxed to all shareholders as if a pro rata distribution

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139. 72 Stat. 1606 (1958).

140. See S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958); S. REP. No. 1622, 83d Cong., 2d Sess. 119 (1952).

141. I.R.C., § 1372(a).

142. I.R.C., § 1371(a).

143. I.R.C., § 1504.

144. I.R.C., § 1372(b).

145. I.R.C., § 1373(b).

146. I.R.C., §§ 1373(d), 1375(a).

147. I.R.C., §§ 1372(b)(1), 1373(a).

148. Comment, 75 HARV. L. REV. 776, 792 (1962). Bills to prevent shareholder-employees from enjoying this best of two possible worlds have been introduced in Congress, but failed to come to a vote. *Id.* at 792 n.96.

were made on the last day of the taxable year.<sup>149</sup> This offers some income shifting possibilities. If each "member" of the firm owns one share or an equal number of shares, regardless of whether such person would be a senior partner or a junior partner in a conventional partnership, the undistributed taxable income would be divided equally among all shareholders, thus keeping unwanted income out of the hands of the members of the firm in the highest tax brackets.<sup>150</sup>

Unfortunately, however, the very complexity of Subchapter S has caused several problems.<sup>151</sup> As concerns the electing professional corporation, some of these problems warrant further discussion in detail.

The portion of an electing corporation's income not actually distributed in a particular year is taxed on a "as if" basis at the end of the year. The amount of such "as if" dividends is then added to the basis of the stock.<sup>152</sup> Basis is then reduced when the previously taxed income is actually distributed in a later year, such distribution being tax free.<sup>153</sup> Dividends may be earmarked either as to current or prior years' income.<sup>154</sup> If the election is terminated, however, distributions thereafter will be treated as coming out of current corporate earnings, not the undistributed taxable income of prior election years on which the tax has already been paid.<sup>155</sup>

To qualify under Subchapter S, a corporation can have no more than ten shareholders,<sup>156</sup> and issuance of shares to more than ten persons will terminate an election.<sup>157</sup> This presents troublesome problems for the professional corporation which desires to operate much as it would if a partnership. If, in an organization of ten members, a retiring "partner" keeps his shares, or because of his death they remain outstanding, the firm will not be able to admit new practitioners as shareholders. Or, if the shares held by a deceased shareholder are distributed to several legatees, the number of shareholders may become too great. If shares become part of a trust,

149. I.R.C., § 1373(b).

150. See the illustrations given in Treas. Reg. § 1.1373-1(g). As concerns a professional corporation, it is presumed that a "senior" member's salary or other compensation would be higher than that of a "junior" member's.

151. See Axelrad, *Choice of Form: Partnership, Corporation, or In-Between*, N.Y.U. 19TH INST. ON FED. TAX 361 (1961); Greene, *Practitioners' Experiences With Subchapter S Reveal Many Doubts, Fears; Use Is Limited*, 10 J. TAXATION 130 (1959).

152. I.R.C., § 1376(a).

153. I.R.C., §§ 1373(b), 1375(b)(1).

154. I.R.C., § 1375(d)(1).

155. See Hart, *Automatic Termination, A Real Danger to Electing Corporation*, 10 J. TAXATION 138 (1959).

156. I.R.C., § 1371(a)(1).

157. I.R.C., § 1372(e)(3).



the election is automatically terminated.<sup>158</sup> Needless to say, careful planning can prevent these things from happening, but it would seem that somewhere one reaches a point of diminishing returns. It may be that the rigid requirements of Subchapter S would work a revolution in the organization of law firms, so that even the largest firms would have a very small number of shareholders, with the rest being associate employees. Perhaps, however, this would run against the grain of a profession which has long equated partnership in the firm with professional achievement.

A "small business corporation" can have only one class of stock.<sup>159</sup> Any differences as to voting rights, dividend rights, or liquidation preferences will be considered as creating a different class of stock.<sup>160</sup> Thus, the professional corporation would have to pay the same dividends and afford the same right to participate in management to all shareholders, whether "senior partners" or "associates," or be disqualified. On the other hand, the professional corporation or association acts all provide that no layman can exercise the rights of a shareholder in professional organizations. When an estate owns shares, but due to the incorporation statute cannot exercise the right to elect the management of the corporation, will this be held to create a second class of stock, and terminate the Subchapter S election?

An election under Subchapter S must be made by all shareholders of the corporation,<sup>161</sup> within the first month of the taxable year or the preceding month,<sup>162</sup> and remains in effect until terminated. A new shareholder must consent to the election, or it terminates.<sup>163</sup> The Regulations require consent to be filed within 30 days after becoming a new shareholder.<sup>164</sup> This suggests a danger: a dissident member of an incorporated professional firm, unable to sell his shares, could exercise his spite by terminating the firm's election. The same could be done by the executor of an estate.

In order to retain substantial control over the admission of new practitioners to the firm, *i.e.*, making them shareholders, and to assure continued qualification as a small business corporation, the transferability of shares should be restricted and redemption provided for in certain situations. The corporation should have the first opportunity to purchase in the event of transfer, if the proposed transferee does not meet the approval of the other

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158. I.R.C., § 1371(a)(2); Treas. Reg. 1.371-1(e) (1959).

159. I.R.C., § 1371(a)(4).

160. Treas. Reg. § 1.1372-4(b) (1959).

161. I.R.C., § 1372(a).

162. I.R.C., § 1372(c)(1).

163. I.R.C., § 1372(e)(1).

164. Treas. Reg. § 1.1372-4(b).

practitioners in the firm. In view of Subchapter S, an arrangement whereby new shareholders are issued stock only by the corporation, the by-laws of which would require a unanimous vote of the present shareholders, and an arrangement for automatic redemption of shares of deceased or retired shareholder-members, would be most effective.<sup>165</sup> Again, however, it will be remembered that the "Kintner" Regulations require that each member must have the power, without consent of the other members, to substitute another person for himself in holding his interest in the corporation or association.<sup>166</sup>

### E. *Ethical Considerations*

Objections to professional people incorporating are based in part merely upon the fact that the solo practitioner and the partnership are the traditional forms of offering professional services. This feeling for the traditional way of doing things is so strong that it was once questioned whether a lawyer should become the employee of a corporation. However, there are valid objections to the professional corporation. Imposing an entity between the lawyer and client might indeed weaken a highly individual and confidential relationship. Since the lawyer would be an employee of the professional corporation, and probably also a stockholder in it, his primary duty might be to his employer rather than to his client. Furthermore, since the client would be doing business with the corporation rather than the individual practitioner, this might insulate the lawyer from liability for his negligence. Again, the corporate attribute of free transferability of shares could result in the transfer of shares, carrying with them the right to elect the management of the law firm, into the hands of unlicensed laymen. Finally, while the individual lawyer is rigorously examined, licensed and disciplined by his profession, the corporate entity might not be.<sup>167</sup>

A general answer to all these objections is that the professional man practicing in corporate form will remain an individual member of his profession, with all its ethical duties, and subject to its regulations. This is so because legislatures and courts, being aware of the objections to professional corporations, have drawn the statutes and court rules to meet these very problems. Thus the American Bar Association's Committee on Professional Ethics has given its approval, conditioned upon such restrictions

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165. See Jones, *The Professional Corporation*, 27 *FORDHAM L. REV.* 353, 361 (1958).

166. See the discussion *supra* at notes 76-82 and accompanying text.

167. For a more detailed list of such objections see Jones, *supra* note 166, at 354.

and safeguards, to professional corporations for members of the legal profession.<sup>168</sup> The medical profession has actively explored the possibilities of corporate practice,<sup>169</sup> which seems to have enjoyed legal approval in Missouri for half a century.<sup>170</sup> Accountants apparently occupy a similar position.<sup>171</sup>

Apart from such general matters, however, lawyers seeking to practice their profession in the corporate form face a special problem. Because of their historic role as officers of the courts, most state courts assert a power to regulate their admission to practice and manner of practice, without regard to what the legislature has to say on the subject.<sup>172</sup> This position is supported by the fact that most state constitutions make explicit the separation of the government into three separate branches—executive, legislative, and judicial—while in the United States Constitution this is only implicit. Furthermore, most state constitutions give the state supreme court the right to regulate the practice of law, while the United States Supreme Court's jurisdiction is only that set out in Article III, in which such power is not granted.<sup>173</sup>

It is arguable that under the Missouri Constitution only the Supreme Court could authorize a professional corporation for lawyers.<sup>174</sup> In *Clark v Austin*,<sup>175</sup> the Supreme Court punished for contempt of court three persons who had engaged in the unauthorized practice of law. The court relied upon a statutory definition of the practice of law, the statute making such unauthorized practice a misdemeanor. One judge concurred in the result, but reasoned that the statute was invalid on the ground that only the court could define the practice of law.<sup>176</sup> The majority held that the legislature could define practice of law so long as it did not attempt to frustrate the power of the court to define and regulate the practice of law and admission

168. Opinion No. 303, 48 A.B.A.J. 159 (1962).

169. See Jones, *supra* note 166, at 355-58.

170. State *ex inf.* Sager v. Lewin, 128 Mo. App. 149, 106 S.W. 581 (St. L. Ct. App. 1907).

171. § 326.020, RSMo 1959, authorizes accountants to practice their profession in corporate form, even though the accounting profession flatly forbids it as a matter of professional ethics, Rule 11, *Rules of Professional Conduct, American Institute of Accountants*, 1 C. P. A. HANDBOOK 6 (1950).

172. See, e.g., *Heiberger v. Clark*, 148 Conn. 177, 169 A.2d 652 (1961); *In re Day*, 181 Ill. 73, 54 N.E. 646 (1899); *Opinion of the Justices*, 289 Mass. 607, 194 N.E. 313 (1935); *Olmstead's Case*, 292 Pa. 96, 140 Atl. 634 (1928).

173. As to the nature and extent of courts' power over attorneys generally, see *Comment*, 47 IOWA L. REV. 984, 985 (1962).

174. See MO. CONST. art. 5, §§ 1,5. See also MO. SUP. CT. R. 4.35. On separation of powers between the branches of the government, see MO. CONST. art. 2.

175. 340 Mo. 467, 101 S.W.2d 977 (1937).

176. *Id.* at 979.

to the bar. In *Hoffmeister v. Tod*,<sup>177</sup> the court unanimously adopted the theory of co-ordinate power of the court enunciated in *Clark*. Thus it would appear that the Supreme Court could, consistently with this line of cases, ignore a statute purporting to permit lawyers to practice in a corporate form.

Where the courts have had their say in the past they have generally manifested a hostile attitude toward a corporation of lawyers. *In Re Co-operative Law Co.*<sup>178</sup> represents the classic viewpoint, laid down half a century ago by the New York Court of Appeals, to the effect that a lawyer must work for his client, not for a corporation-employer.

More recently the courts seem to have taken three approaches to the current pressure for professional incorporation. Exemplifying one such approach, Florida's Supreme Court amended its bar integration rule and code of ethics to enable lawyers to qualify under that state's new professional corporation act.<sup>179</sup> However, it warned members of the bar that they must preserve "all of the traditional obligations and responsibilities of the lawyer. . . ."<sup>180</sup> The court emphasized that

The individual practitioner, whether a stockholder in a corporation or otherwise, will continue to be expected to abide by all of the Rules and Canons of professional ethics heretofore or hereafter required of him. The corporate entity as a method of doing business will not be permitted to protect the unfaithful or the unethical. . . . [T]he corporate entity itself will automatically come within the ambit of our jurisdiction in regard to discipline. In addition to the individual liability and responsibility of the stockholder, the corporate entity will be liable for the misprisions of its members to the extent of corporate assets. . . .<sup>181</sup>

Thus the court upon petition added its *imprimatur* to what the legislature had authorized.

Ohio recently enacted a statute which specifically authorized lawyers, and others, to form professional corporations. Representing the second type

177. 349 S.W.2d 5 (Mo. 1961). *Accord*, *In re Richards*, 333 Mo. 907, 63 S.W.2d 672 (1933); *State ex rel. Selleck v. Reynolds*, 252 Mo. 369, 158 S.W. 671 (1913); *Ex parte Creasy*, 243 Mo. 679, 148 S.W. 914 (1912). The *Hoffmeister* decision seems to be in line with the general American rule.

178. 198 N.Y. 479, 92 N.E. 15 (1910). *Accord*, *Boykin v. Hopkins*, 174 Ga. 511, 162 S.E. 796 (1932); *People v. Merchants' Protective Corp.*, 189 Cal. 531, 209 Pac. 363 (1922); *People ex rel. State Bar Ass'n. v. People's Stockyards State Bank*, 344 Ill. 462, 176 N.E. 901 (1931); *State v. Merchants' Protective Corp.*, 105 Wash. 12, 177 Pac. 694 (1919).

179. *In the Matter of the Florida Bar*, 133 So.2d 554 (Fla. 1961).

180. *Id.* at 556.

181. *Ibid.*

of approach, the Ohio Supreme Court held that until the court, through its rules for admission to practice, saw fit to permit a corporate entity to practice law, the secretary of state did not even have to accept for filing articles of incorporation from a corporation authorized by the statute!<sup>182</sup> The court based its holding upon its "inherent power to prescribe standards for admission to the practice" which it held was "inherent in the judicial branch of government. . . ."<sup>183</sup> A statute also gave the court the power to admit to practice, but the court apparently regarded this as superfluous.

Illustrative of the third and most liberal approach, the Colorado Supreme Court recently amended its rules to permit lawyers to form professional service corporations under the Colorado Corporation Code, a general business corporation act.<sup>184</sup> However, the court rule spells out the same kind of requirements that are found elsewhere in special statutes.

It is submitted that the *Hoffmeister*<sup>185</sup> decision may indicate that the Missouri Supreme Court will take the same attitude manifested by the Ohio court; that is, the court will have to authorize lawyers to practice in corporate form, regardless of what general provisions the legislature may enact concerning professional corporations.

Assuming finally that it becomes possible for Missouri lawyers to practice in the corporate form, and that the Supreme Court will not wish to give the professional corporation of lawyers any advantages not enjoyed by lawyers practicing in partnerships, the Missouri court rules themselves present several miscellaneous problems. For instance, partnerships of lawyers cannot include persons who are not members of the Missouri Bar, duly licensed to practice in this state and amenable to professional discipline; nor can the partnership have an associate who does not meet this qualification.<sup>186</sup> This eliminates a partnership of lawyers practicing in various cities in several states, which most states allow. How will this affect a corporation of lawyers? Furthermore, in Missouri a partnership of lawyers cannot use a trade name, but must use the names of living, active partners.<sup>187</sup> The Florida Supreme Court amended its rules to allow the use of a fictitious name by a professional corporation of lawyers.<sup>188</sup> Colorado's

182. *State ex rel. Greene v. Brown*, 173 Ohio St. 114, 180 N.E.2d 157 (1962), 31 U. CINC. L. REV. 341 (1962), 14 SYRACUSE L. REV. 104 (1962).

183. 173 Ohio St. at 115, 180 N.E.2d at 158.

184. COLO. SUP. CT. R. 265 (1961).

185. *Supra* note 178.

186. MO. SUP. CT. R. 4.33.

187. *Ibid.*

188. In the Matter of the Florida Bar, *supra* note 180, at 558, 559.

court rule<sup>189</sup> and the American Bar Association's Committee<sup>190</sup> require the use of individual's names, as in the partnership's firm name, plus the words "professional company" or "professional corporation" or abbreviations thereof. Apparently this is a matter that would have to be dealt with by court rule. The canon that lawyers and members of other professions, or lawyers and nonprofessionals, cannot form a partnership where their activities will consist in part of practicing law, would of course apply to the professional corporation.

IV. "DIRECT" METHODS OF ESTABLISHING EQUALITY—  
 THE SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

A. *Background*

The foregoing sections have dealt with what might be termed "indirect" methods of achieving tax equality in the deferred compensation field; that is, with methods by which the self-employed individual might insure a designation of himself as a "corporate" or "association" employee. Quite apart from such attempts, however, there exists, and has always existed, one very simple method of providing tax equality for the self-employed—simple at least in its approach: direct legislation by Congress. In reality, it was in this area that the greatest opportunity for success appeared to lie. Thus, it was with a sigh of relief that most self-employed professionals greeted the enactment of the Self-Employed Individuals Tax Retirement Act of 1962. And thus, in similar fashion, it was with a sigh of despair that most of them later greeted the realization that the act was far from the great equalizer desired.

The Congressional struggle for some measure of tax equality for self-employed individuals dates back to the middle 1940's, when various groups first began approaching the problem.<sup>191</sup> The original Keogh-Reed bill, which

189. *Supra* note 185.

190. *Supra* note 169.

191. For a more complete history of the early work in this area, see REPORT OF COMMITTEE ON FEDERAL INCOME TAX SECTION OF TAXATION OF A.B.A. 78 (1947); Bronston, *Progress Report on Self-Employed Retirement Act*, 98 TRUSTS & ESTATES 1204 (1959); Corbett, *Retirement for Self-Employed*, 97 TRUSTS & ESTATES 632 (1958); Donohue, *Smathers-Keogh-Simpson Legislation Retirement Savings for the Self-Employed*, 45 A.B.A.J. 795 (1959); Keogh, *Tax Equity for the Self-Employed*, 47 A.B.A.J. 665 (1961); Polisher, *The Self-Employed Individual's Retirement Bill of 1959*, 37 TAXES 321 (1959); Rapp, *Pensions for the Self-Employed: The Treasury Department—Finance Committee Plan*, 16 TAX L. REV. 227 (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); Silverson, *A New Tax Proposal*,

evolved from the work of some of these groups, was first introduced in Congress in the late summer of 1951.<sup>192</sup> It provided for an exclusion of the lesser of 10% of earned income or \$7500, when paid into a restricted retirement fund, with a lifetime limit of \$150,000 and a five year carryover on unused exclusions. The bill granted tax exemption to the trust on its earnings; the trustee of the fund was required to be a bank; and investments were limited to those which were legal for investment of trust funds by such a bank. Distributions could not be made without penalty prior to age sixty except in the event of total and permanent disability. When made, lump sum distributions were to be given capital gains treatment, as are distributions from qualified employee plans; installment or annuity payments were taxable on receipt at ordinary rates.

The bill was reintroduced at each session of Congress in substantially the same form until 1955,<sup>193</sup> when certain changes of a technical nature were made to integrate its provisions with the Internal Revenue Code of 1954. The bill was also amended in committee to reduce the dollar limit on the annual exclusions from \$7,500 to \$5,000, and the aggregate life-time exclusions from \$150,000 to \$100,000.

In 1957, when the bill was reintroduced, the exclusion was changed to a deduction from gross income, with the limits of the lesser of 10% of net earnings from self-employment income or \$5,000. The lifetime limit of \$100,000 was retained from the 1955 draft of the bill.

In 1958 the bill was passed by the House after a committee amendment had reduced the annual deductible amount to the lesser of 10% of net earnings from self-employment or \$2,500, and cut the lifetime limit on deductions to \$50,000 for any one individual. The bill was lost in the last minute rush of the Senate for adjournment and thus failed of enactment in 1958.<sup>194</sup>

Although reintroduced at each session of Congress thereafter, it was not until 1962 that H.R. 10,<sup>195</sup> in its modified form, was finally enacted after a conference committee had reconciled the House and Senate versions

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64 AM. MERCURY 345 (1947); Silverson, *Earned Income and Ability to Pay*, 3 TAX. L. REV. 299 (1947); Silverson, *Taxation and the Self-Employed: A Study in Retrogression*, 41 A.B.A.J. 50 (1955); 114 J. OF ACCOUNTANCY 24 (1962); 114 J. OF ACCOUNTANCY 26 (1962).

192. H.R. 4371 (Keogh) and H.R. 4373 (Reed), 82nd Cong., 1st Sess. (1951).

193. H.R. 9 (Jenkins) and H.R. 10 (Keogh), 84th Cong., 1st Sess. (1955).

194. See the chart at 107 CONG. REC. 9466 (1961), which indicates the trend of limitations on contributions and deductions permitted in bills introduced before the House.

195. Public Law 87-792, 76 Stat. 809 (1962).

of the bill. It became effective for the tax years beginning after December 31, 1962.<sup>196</sup>

As finally enacted, H.R. 10 provides *some* of the benefits of the qualified employee plans to the self-employed by treating the latter as their own employees for this purpose.<sup>197</sup> The provisions of the bill cover all persons presently subject to the self-employment tax as well as doctors and ministers, who are not presently covered by that tax.<sup>198</sup>

### B. *Modus Operandi of H.R. 10*

Designed to operate within the existing Code framework, the changes made by H.R. 10 occur primarily in the form of additions to Code section 401. These may be briefly treated as follows:

- (1) The basic concept of "employee" is broadened to *include*<sup>199</sup> any individual who has "earned income" derived from "self employment earnings," as those two terms are defined by Code sections 911 (b) and 1402 (a) respectively, for the taxable year<sup>200</sup> or any prior taxable year.<sup>201</sup>
- (2) Segregated within the general concept of "employee" are those defined in Code section 401 (c)(3) as "owner-employees."<sup>202</sup> As to a plan including such persons, rather stringent new requirements

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196. Self-Employed Individuals Tax Retirement Act of 1962 § 8, 76 Stat. 831 (1962).

197. For a general discussion of H.R. 10 see Adams, *Retirement Plans for the Self-Employed Lawyer?*, 17 RECORD 528 (1962); Becker, *Self-Employed Retirement Plans and H.R. 10*, 49 A.B.A.J. 39 (1963); Coughlin, *The Self-Employed Individuals Tax Retirement Act of 1962*, 13 MONTHLY DIGEST OF TAX ARTICLES 1 (Nov. 1962); Donnelly, *Federal Tax Law for Self-Employed Individuals: The Application of the New Retirement Plan to the Legal Profession*, 23 GAVEL 12 (1963); Epstein, *Tax Deduction Retirement Plans for the Self-Employed: Present Plans and Future Prospects*, 2 L. OFF. ECON. & MAN. 7 (1962); Forster, *H.R. 10—What Does It Profit A Man?* 101 TRUSTS & ESTATES 978 (1962); Johnson, *Keogh Act: Past, Present, and Future*, 17 J. AM. SOC'Y C.L.U. 101 (1963); MacNeill, *What Price H.R. 10 Today?*, 102 TRUSTS & ESTATES 9 (1963); White & Peterson, *Some Questions and Answers: The Keogh Act*, 37 CALIF. S.B.J. 909 (1962); 36 CONN. B.J. 271 (1962); 31 FORDHAM L. REV. 519 (1963); 31 U. CINC. L. REV. 434 (1962).

198. I.R.C., § 401(c)(2)(A)(i).

199. The word "include" is here emphasized to direct attention to the fact that the definition of "employee" as used in section 401 (c) is not all-inclusive, but merely an addition to the definition under the older law.

200. See also I.R.C., § 401(c)(1)(A), which includes those who would have fallen within the definition of § 401(c)(1) except for the fact that no net profit was shown for the year.

201. I.R.C., § 401(c)(1)(B).

202. It should be noted that this definition does not cover all those covered under § 401(c)(1). See generally §§ 1402(c)(2) and 401(c)(2)(A).



are imposed, in addition to the ones enumerated in section 401 (a). These restrictions are discussed in some detail in a later section of this article.

It would be helpful, at this point, to recall the general discussion of qualified deferred compensation plans set forth previously in section II. Since H.R. 10 is, in essence, simply an enlargement of the definition of "employee," the basic types of plans which may be established remain unchanged, with one relatively minor addition. Thus the provisions of H.R. 10 extend to the self-employed the same variety of plans formerly available only to "regular" employees. Briefly, the self-employed individual may set up either a pension plan or a profit-sharing plan. (The stock bonus plan is inapplicable to the self-employed individual because of the nature of his business organization.) It should be noted, however, that as to profit sharing plans benefiting owner-employees H.R. 10 has revived the requirement of a definite formula for determining the contributions to be made on behalf of persons benefited.<sup>203</sup> As to corporate plans this requirement had been dropped by the Treasury in 1956,<sup>204</sup> but apparently Congress felt a need<sup>205</sup> to revive the provision as to qualified plans for the self-employed.

Another inexpensive and convenient method of establishing a qualified plan is the bond purchase plan, newly established by H.R. 10. The self-employed individual (the plan is applicable to corporations as well) can invest the contributions for himself and his employees, if any, by direct purchase of a new series of U.S. Government bonds designed to meet the requirements for investment of these funds.<sup>206</sup>

### C. Coverage Necessary to Qualify the Plan

For purposes of the following discussion, three terms will be used to classify the various types of persons who may be covered by a qualified plan. "Regular employee" is any person who fits the pre-1962 classification of an employee. "Self-employed person" is the broad term covering all self-employed individuals regardless of their ownership interest. "Owner-employee," a new classification created by H.R. 10, is defined<sup>207</sup> as a self-em-

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203. I.R.C., § 401(d)(2)(B).

204. T.D. 6189, 56 Cum. Bull. 972 (1956).

205. See S. REP. No. 992, 87th Cong., 1st Sess. 19 (1961). See also proposed Treas. Reg. § 1.401-12(d), 28 Fed. Reg. 3413 (1963).

206. S. REP. No. 992, 87th Cong., 1st Sess. 19 (1961). For background on the bond funding idea see Silverson, *Earned Income and Ability to Pay*, 3 TAX L. REV. 299 (1948).

207. I.R.C., § 401(c)(3).

ployed person either owning an unincorporated trade or business, or a partner owning at least ten percent of either the capital or profits of the partnership. A "self-employed person not an owner-employee" is any self-employed person who does not own ten percent of a partnership. Most of the new restrictions apply to plans which benefit one or more owner-employees.

Qualified plans benefiting owner-employees must meet the requirements imposed on qualified plans for regular employees,<sup>208</sup> as well as additional requirements set up by H.R. 10. Briefly, these new provisions state that the trustee must ordinarily be a bank;<sup>209</sup> that employees' rights to contributions when made must be non-forfeitable;<sup>210</sup> that there must be a definite formula for determining contributions for employees to a profit-sharing plan;<sup>211</sup> that all full-time employees with three years service must be covered;<sup>212</sup> that contributions may not be provided for any owner-employee unless he has consented to coverage, and that no benefits may be paid to him prior to age 59½ unless he becomes permanently disabled;<sup>213</sup> that excess contributions and premature distributions are prohibited;<sup>214</sup> that the plan may be integrated with Social Security payments if not more than one-third of the deductible contributions made by the employer are for the benefit of owner-employees;<sup>215</sup> that a deceased owner-employee's interest must be distributed within five years of his death to his beneficiary or applied to purchase an immediate annuity;<sup>216</sup> that excess contributions and attributable income must be repaid to an owner-employee on whose behalf they were made;<sup>217</sup> that a qualified plan which covers an owner-employee who controls another trade or business<sup>218</sup> must be combined with any plan established for such other trade or business for purposes of determining whether combined plans meet the requirements for coverage, contribution limits and deductions;<sup>219</sup> that the plan must not provide contributions or benefits for any owner-employee who controls another trade or business unless the employees of the controlled trade or business are covered by a

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208. I.R.C., § 401(a).

209. I.R.C., § 401(d)(1).

210. I.R.C., § 401(d)(2)(A).

211. I.R.C., § 401(d)(2)(B).

212. I.R.C., § 401(d)(3).

213. I.R.C., § 401(d)(4).

214. I.R.C., § 401(d)(5).

215. I.R.C., § 401(d)(6).

216. I.R.C., § 401(d)(7).

217. I.R.C., § 401(d)(8).

218. I.R.C., § 401(d)(9)(B).

219. I.R.C., § 401(d)(9)(A).

qualified plan;<sup>220</sup> and that contributions on behalf of an owner-employee may be made only from earned income derived with respect to the trade or business for which the plan was established.<sup>221</sup> These requirements are discussed in more detail in the sections following.

There is no problem in determining who must be covered under a qualified plan established by an owner-employee. The rules are very clear that *all* employees of the owner-employee *must* be covered by the plan if any benefits are to be provided for the owner-employee.<sup>222</sup> The only exceptions provide that the term "employee" does not include a person employed for less than three years, or one who is employed part time—twenty hours or less per week or not more than five months in a calendar year.<sup>223</sup> However, if an owner-employee establishes a qualified plan for his employees only and does not receive benefits himself, the more liberal coverage rules governing qualified employee plans apply, permitting reasonable classification of employees for purposes of providing benefits.<sup>224</sup>

An important term is "earned income,"<sup>225</sup> defined as net earnings from self-employment as defined in § 1402 (a). The limit on contributions which may be made on behalf of an owner-employee is computed as a percentage of his earned income, in turn derived from his net earnings from self-employment.<sup>226</sup>

Where the owner-employee controls two or more businesses, he must treat all the businesses as one for purposes of determining employee coverage.<sup>227</sup> Thus the professional man who practices alone and has no employees in that practice will be forced to cover the employees of another business which he controls<sup>228</sup> as an owner-employee in order to establish a qualified plan to which he may make contributions for himself as an owner-employee. This provision presents a decided disadvantage to be considered by an owner-employee who is contemplating the establishment of a qualified

220. I.R.C., § 401(d)(10).

221. I.R.C., § 401(d)(11).

222. I.R.C., § 401(d)(3).

223. *Ibid.*

224. I.R.C., §§ 401(a)(3), (5).

225. I.R.C., § 401(c)(2)(A).

226. I.R.C., § 404(e)(1). A further complication is introduced by the definition of earned income when both personal services and capital are material income producing factors. Section 911 (b) defines earned income in such a situation as up to 30% of the net profits from such trade or business. Section 401(c)(2)(B) adds the requirement that the taxpayer render *substantially* full time services; provided, however, that the first \$2,500 of net profits are considered as earned income without regard to the percentage computation under section 911(b).

227. I.R.C., §§ 401(d)(9)(A), (B).

228. I.R.C., § 401(d)(9)(B).

plan: will the contributions for the benefit of employees of the controlled business overbalance the tax advantage to be gained by establishing the plan for himself in his solo practice? Furthermore, the benefits provided for the employees of the controlled business must be as favorable as the ones for his benefit.<sup>229</sup> However, a self-employed person owning 10% or less of a partnership, and therefore falling outside the owner-employee classification, would not be forced to establish a qualified plan for employees of a business which he controls as an owner-employee in order for contributions to a qualified plan to be made for him by the partnership.<sup>230</sup>

If a partner owning more than 10% of the partnership also controls another business as an owner-employee, he can escape the necessity of establishing a plan for the employees in the controlled business by refusing coverage to himself under the plan established by the partnership.<sup>231</sup> Since no benefits will be provided under the plan for him, he is not under an obligation to provide equal benefits for his employees.<sup>232</sup> While an owner-employee must consent to coverage before contributions to a qualified plan may be made for his benefit, the proposed Regulations announce that this consent may be implied from the fact that contributions are in fact made on his behalf.<sup>233</sup>

Closely related to the problem of necessary coverage to establish a qualified plan is the problem of when the benefits under the plan must vest in the beneficiaries. Under corporate plans, the time for vesting may be deferred for a period of years or until retirement. A qualified plan including an owner-employee, however, must provide for immediate vesting in the employees at the time the contributions are made.<sup>234</sup> Furthermore, under an amendment to the Code applicable to *all* qualified plans, contributions must be vested in the benefited employees upon termination of the plan,<sup>235</sup> a provision which merely enacts a prior requirement insisted upon by the Treasury before approving a plan.<sup>236</sup>

#### D. *Funding Methods Available*

A wide variety of funding devices are available in establishing a qualified plan, ranging from a formal plan to simple and direct plans involving

229. I.R.C., § 401(d)(10).

230. I.R.C., § 401(c)(3).

231. I.R.C., § 401(d)(4)(A).

232. I.R.C., §§ 401(d)(4)(A), (d)(10).

233. Proposed Treas. Reg. § 1.401-12(b)(1), 28 Fed. Reg. 3412 (1963).

234. I.R.C., § 401(d)(2)(A).

235. I.R.C., § 401(a)(7).

236. See Rev. Rul. 61-157, 1961-2 Cum. Bull. 88, part 5(c)(2).

the purchase of nontransferable annuities or special-issue government bonds.

If the number of employees and the expected contributions warrant the expense and trouble involved, the employer may create a trust plan. If a self-employed individual sets up a trust plan for the exclusive benefit of regular-employees, there is no change in the present rules and the employer may be the trustee if he so desires. If an owner-employee is covered by the trust plan, however, several new rules are applicable in addition to prior requirements.<sup>237</sup> In such a case the trustee must be a bank as defined in section 401(d)(1), although another person, including the employer, may be granted the power of control over investment of the trust funds.<sup>238</sup> Presumably the funds may be invested in any proper trust investment for a bank under applicable law. An exception to the bank rule, allowing a wider range of investments, is provided where the trustee funds the trust through the exclusive use of annuity, endowment or life insurance contracts, and the insurance company supplies certain required information about owner-employees.<sup>239</sup>

The scope of prohibited transactions between a qualified trust and the employer has been expanded by H.R. 10 where the trust covers any owner-employees who control the business. The trustee is absolutely prohibited from loaning any part of the trust fund to, paying any compensation for services rendered to it by, buying any property from, or selling any property to an owner-employee who controls<sup>240</sup> the trade or business for which the plan was established.<sup>241</sup> These are absolute prohibitions and the presence of full and fair consideration does not alter them. Congress felt the need for tightening the rules on prohibited transactions because of the extreme difficulty in policing the number of small trusts that could be established under H.R. 10.<sup>242</sup>

An alternative funding method is the use of a custodial account, which, if certain requirements are met, is treated as if it were a trust.<sup>243</sup> The custodian must be a bank,<sup>244</sup> and the investments of all funds must be either exclusively in regulated investment company stock<sup>245</sup> (mutual fund shares) or in annuity, endowment, or life insurance contracts.<sup>246</sup>

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237. I.R.C., §§ 401(a), 503.

238. I.R.C., § 401(d)(1).

239. *Ibid.*

240. I.R.C., § 401(d)(9)(B).

241. I.R.C., § 503(j)(1).

242. H.R. Rep. No. 378, 87th Cong., 1st Sess. 14 (1961).

243. I.R.C., § 401(f).

244. I.R.C., § 401(f)(1)(B).

245. I.R.C., § 401(f)(1)(C)(i).

246. I.R.C., § 401(f)(1)(C)(ii).

Other methods of funding include the direct purchase of (1) nontransferable annuity contracts from an insurance company without the intervention of a trust or custodial account;<sup>247</sup> (2) nontransferable face-amount certificates as defined in section 2(a)(15) of the Investment Company Act of 1940;<sup>248</sup> or (3) special series United States bonds.<sup>249</sup> All of these methods are similar in that they tie up the plan funds until the retirement of the beneficiary. A review of the characteristics of the bonds illustrates this clearly. The bonds are nontransferable,<sup>250</sup> provide interest or yield only upon redemption,<sup>251</sup> and may not be redeemed prior to age 59½, death, or permanent disability.<sup>252</sup> As a finishing touch, Congress provided that interest on the bonds must stop within five years of the bond owner's death,<sup>253</sup> "to prevent their use for purposes other than retirement."<sup>254</sup>

### E. Contributions & Deductions

We come now to a section that goes to the very heart of the self-employed professional's problem. Just how much can an owner-employee or other self-employed individual contribute to a qualified plan for his own benefit, and to what extent may he deduct the amount of his contribution?

#### 1. Contributions

Contributions may be of two kinds: (1) those made by the employer for the employee, and (2) those made by the employee for his own benefit. Only the former are deductible. This distinction is preserved in H.R. 10 and must be kept in mind in the following discussion.

An employer, as such, may contribute to a qualified plan, for the benefit of an owner-employee, the lesser of 10% of his earned income<sup>255</sup> or \$2,500.<sup>256</sup> This is a maximum figure, and if an owner-employee is covered by two or more qualified plans the aggregate of the contributions cannot exceed this amount.<sup>257</sup> In computing the amount of contribution, however, any amount allocable to the purchase of *current* insurance protection is to be disregarded.<sup>258</sup>

247. I.R.C., § 404(a)(2).

248. 15 U.S.C., § 80(a)(2). See I.R.C., § 401(g).

249. I.R.C., § 405.

250. I.R.C., § 405(b)(1)(E).

251. I.R.C., § 405(b)(1)(A).

252. I.R.C., § 405(b)(1)(D).

253. I.R.C., § 405(b)(1)(C).

254. S. REP. No. 992, 87th Cong., 1st Sess. 20 (1961).

255. Earned income is defined in § 401(c)(2).

256. I.R.C., § 401(e)(1).

257. *Ibid.*

258. I.R.C., § 404(e)(3).

The only exception to the limit on maximum contributions which may be made on behalf of an owner-employee is in the case of certain level premium insurance contracts used to invest the funds. In this instance a three year averaging provision is employed, allowing the annual contributions to be calculated on the basis of the average annual earned income for the three years.<sup>259</sup> Only in this limited situation are the penalties for excess contributions inapplicable.

The self-employed individual who is not an owner-employee is in an unusual position. For purposes of determining the contribution made on his behalf he is considered an employee, with the more liberal employee rules applying.<sup>260</sup> As to the amount he may deduct for the contribution made on his behalf, however, he is treated as an owner-employee.

If regular employees are covered under the plan, the contributions for owner-employees may not be more favorable than those made for the regular employees. Such discrimination will result in disqualification of the plan.<sup>261</sup> Likewise, a plan is disqualified if it permits "excess contributions"<sup>262</sup> to be made by or for an owner-employee. If only owner-employees are covered, an "excess contribution" simply means any contribution over 10% of earned income or \$2,500, whichever is less.<sup>263</sup> If regular employees and self-employed persons not owner-employees are also covered, the term means: (1) any amount contributed by the employer for an owner-employee in excess of the amount deductible;<sup>264</sup> (2) a contribution made by an owner-employee *as an employee* in excess of the rate permitted regular employees;<sup>265</sup> (3) any amount contributed by an owner-employee *as an employee* in excess of the lesser of the 10% of earned income or \$2,500 limitation;<sup>266</sup> or (4) contributions by an owner-employee *as an employee* under two or more plans in excess of an aggregate amount of \$2,500.<sup>267</sup>

In computing the allowable contributions which may be made for regular employees covered by the plan, the former more liberal rules apply and there is no dollar limit applicable.<sup>268</sup> If discrimination in favor of such employees should occur as a result of a higher percentage of their salary

259. I.R.C., § 401(e)(3).

260. I.R.C., § 404(e)(1) applies only to owner-employees as defined in § 401(c)(3).

261. I.R.C., §§ 401(e)(1), (2) (A).

262. I.R.C., § 401(e).

263. I.R.C., § 401(e)(1)(A).

264. I.R.C., § 401(e)(1)(B)(i).

265. I.R.C., § 401(e)(1)(B)(ii).

266. I.R.C., § 401(e)(1)(B)(iii).

267. I.R.C., § 401(e)(1)(B)(iv).

268. I.R.C., § 404(a).

being contributed than for the owner-employee, the plan is not disqualified, no penalties attach, and no contributions and attributable income have to be repaid. An important provision is that all amounts credited for the benefit of regular employees must be non-forfeitable at the time of the contribution if an owner-employee is covered by the plan.<sup>269</sup>

If regular employees are covered by a plan including an owner-employee, the plan may require or permit additional contributions to be made by all those covered. These contributions may be made up to limits of 10% of salary by regular employees and 10% of earned income or \$2,500, whichever is less, by owner-employees.<sup>270</sup> Contributions by owner-employees, however, must not be made at a rate which exceeds the permitted rate for the regular employees under the plan.<sup>271</sup> Self-contributions must be made from taxable income for both regular employees and owner-employees; no deduction is allowed for any such contributions, whether voluntary or compulsory under the plan. Even without a deduction, however, the advantage of additional contributions is apparent—the accumulated income from the contributions is tax-free in the hands of the fund until the retirement benefits are received.<sup>272</sup> One point to be kept in mind is that a contribution for an owner-employee may be made only out of his earned income derived from the trade or business for which the plan was established.<sup>273</sup>

The penalty provisions added by H.R. 10 introduce a new concept into this area of the law. A qualified plan covering an owner-employee may not permit excess contributions to be made by or for such owner-employee,<sup>274</sup> if such contributions are made, they must be refunded, along with any attributable income, to the owner-employee for whom they were made, within six months after notice of the excess contribution is mailed by the Internal Revenue Service to the person.<sup>275</sup> The amount refunded is includable in the owner-employee's gross income for the year in which the excess contribution was made. If repayment is not made within the prescribed six month period, the owner-employee must include in his gross income the net income attributable to his interest under the plan for the taxable year when the excess contribution became attributable to him.<sup>276</sup> This continues

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269. I.R.C., § 401(d)(2)(A).

270. I.R.C., § 401(e)(1)(B)(iii).

271. I.R.C., § 401(e)(1)(B)(ii).

272. I.R.C., § 501(a).

273. I.R.C., § 401(d)(11).

274. I.R.C., §§ 401(e)(2)(A), (d)(8)(A).

275. I.R.C., §§ 401(e)(2)(C), (d)(8)(B).

276. I.R.C., § 401(e)(2)(B).



until the excess contribution and the amount of net income included in the owner-employee's gross income because of disqualification of the plan is paid to the owner-employee.<sup>277</sup>

If the excess contribution was wilfully made, several penalties follow. The entire interest of the owner-employee for whom the contribution was made must be paid to him from all plans under which he is covered as an owner-employee;<sup>278</sup> he is disqualified from participating in a qualified plan for the taxable year in which the excess contribution was made and for five taxable years following;<sup>279</sup> and the amounts of this forced distribution are subject to a penalty tax as a premature distribution.<sup>280</sup> From the language used, there apparently is no way to escape this penalty once the determination has been made that the excess contribution was wilful.<sup>281</sup>

It takes little imagination to see that requiring all employees to be covered by a qualified plan which includes the owner-employee adds materially to the cost of the plan to the employer. A possible way to pare these costs is to "integrate" the plan with Social Security.<sup>282</sup> The employer may take into account the Social Security taxes he actually pays on behalf of his employees in determining the net contributions to be made to the plan, if he also takes into account the Social Security taxes he pays on his own account, or would pay if covered, in determining the net contribution to be made on his behalf. Integration of the plan is permitted only if the net contributions on behalf of owner-employees are not more than one-third of the net contributions to the plan as a whole.<sup>283</sup> This provision will effectively block integration of a plan covering one or more owner-employees who earn more than the other employees as a group, which will generally be the case with a professional man or partnership.

## 2. Deductions

If any regular employees are covered under a plan which also benefits owner-employees, the total contributions made on behalf of the regular employees are deductible in accordance with the former rules applied to plans which exclusively benefited regular employees.<sup>284</sup> Also applicable to

277. I.R.C., § 401(e)(2)(D).

278. I.R.C., §§ 401(d)(8)(C), (e)(2)(E)(ii).

279. I.R.C., § 401(e)(2)(E)(iii).

280. I.R.C., § 72(m)(5)(A)(iii).

281. I.R.C., § 401(e)(2)(E)(ii): "[T]here shall be distributed to the owner-employee on whose behalf such excess contribution was wilfully made his entire interest in all plans with respect to which he is an owner-employee; . . ."

282. I.R.C., § 401(d)(6).

283. I.R.C., § 401(d)(6)(A).

284. I.R.C., § 404(a).

such contributions are the provisions permitting carryover to future years of contributions made in the taxable year in excess of the amount deductible.<sup>285</sup> By way of contrast, the deduction permitted for contributions for *self-employed* persons is limited to one-half of the allowable employer contribution for such persons.<sup>286</sup> Inasmuch as such contributions, as previously indicated, are limited to the lesser of 10% of earned income or \$2,500,<sup>287</sup> the maximum deduction for a self-employed individual is \$1,250 per tax year. Further, the regular employees' carryover provisions are expressly stated to be inapplicable to contributions for the self-employed.<sup>288</sup> The special exception permitting larger contributions to be invested in certain insurance contracts under special conditions<sup>289</sup> does not change the limit on the amount of contribution deductible.<sup>290</sup> Finally, in computing the deduction for self-employed persons, amounts spent on current insurance protection are also disregarded,<sup>291</sup> as they are in computing the contributions for an owner-employee.<sup>292</sup>

#### F. *Distributions*

One purpose in setting up a qualified plan for the benefit of a self-employed person is to provide a fund which can be drawn upon by that person when he retires. As might have been anticipated, the provisions of H.R. 10 tightly control distributions to an owner-employee. An owner-employee may not receive any distribution from a qualified plan prior to attaining age 59½, unless he is permanently disabled,<sup>293</sup> without subjecting himself to all the problems of the penalty for premature distributions.<sup>294</sup> If the owner-employee dies before all of his interest has been distributed to him, his remaining interest must, with certain limited exceptions, be distributed within five years or used immediately to purchase an annuity for his beneficiaries.<sup>295</sup> All of the owner-employee's interest must be distributed to him prior to his attaining age 70½,<sup>296</sup> or distributed in accordance with Treasury Regulations (yet to be announced) over the life

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285. I.R.C., §§ 404(a)(1)(D), (a)(3)(A).

286. I.R.C., § 404(a)(10).

287. I.R.C., § 404(e)(1).

288. I.R.C., § 404(a)(9)(B).

289. I.R.C., § 401(e)(3).

290. I.R.C., § 404(e)(1).

291. I.R.C., § 404(a)(10).

292. I.R.C., § 404(e)(3).

293. I.R.C., § 401(d)(4)(B).

294. I.R.C., § 72(m)(5).

295. I.R.C., § 401(d)(7).

296. I.R.C., § 401(a)(9)(A).

expectancy of the owner-employee or the owner-employee and his spouse.<sup>297</sup>

The self-employed person who is not an owner-employee is treated as a regular employee for determining the age at which he may receive distributions. There is no express restriction on the minimum age for a regular employee to receive benefits, but under present corporate plans benefits are commonly payable upon discharge or resignation at any age. Benefits for regular employees under a plan benefiting self-employed persons or the self-employed who is not an owner-employee must begin at age 70½ or at retirement if subsequent to age 70½.<sup>298</sup>

One potential problem that may arise in the administration of a qualified plan is the case of a professional man who joins a partnership as a regular employee, but after a few years becomes a self-employed partner not an owner-employee, and still later becomes a partner owning 10% or more of the capital or profits of the firm—an owner-employee. It is not clear at present just how the contributions made at the various stages in his career should be treated upon his retirement. For example, will the contributions made for him while a regular employee and the income attributable thereto be accorded the same treatment upon distribution as it would if he had remained a regular employee until his retirement?

If the self-employed person takes a lump-sum distribution in liquidation of his interest, he is denied the benefit of capital gains treatment which is accorded the regular employee.<sup>299</sup> Instead, there is a new averaging device available for the receipt of such distributions by the self-employed, limiting the tax to five times the increase in tax which results from including 20% of the "includible portion" of the distribution in gross income for the taxable year.<sup>300</sup> In computing the "includible portion" of any distribution, the amount contributed to the plan by the self-employed person as an employee from after tax dollars is excluded. Periodic distributions made to any self-employed individual from a qualified plan are taxed at ordinary rates to the extent that the payments are not a return of the taxpayer's investment.<sup>301</sup>

Several other benefits enjoyed by regular employees are expressly denied to self-employed persons. The \$5,000 death benefit exclusion available to the beneficiary or estate of an employee<sup>302</sup> is denied the self-employed.<sup>303</sup>

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297. I.R.C., § 401(a)(9)(B).

298. I.R.C., § 401(a)(9)(A).

299. I.R.C., § 402(a)(2).

300. I.R.C., § 72(n)(2).

301. I.R.C., § 72(a)(b).

302. I.R.C., § 101(b)(1).

303. I.R.C., § 101(b)(3).

Likewise, the sick pay exclusion<sup>304</sup> for disability payments, the gift tax exclusion in designating a beneficiary,<sup>305</sup> and the estate tax exclusion for payments made to a beneficiary from a qualified plan upon the death of a regular employee,<sup>306</sup> are made inapplicable to the self-employed by the provisions of H.R. 10.<sup>307</sup> The retirement income credit, however, has been extended to cover self-employed as well as regular employees receiving distributions from qualified plans.<sup>308</sup>

A premature distribution<sup>309</sup> from a qualified plan to an owner-employee results in the imposition of a tax penalty.<sup>310</sup> There is no comparable provision applicable to distributions to regular employees under a qualified plan. If a distribution is made to an owner-employee before age 59½ or permanent disability prior to that age, the amount of the penalty imposed depends upon the size of the distribution. If the amount received equals or exceeds \$2,500, the tax is 110% of the increase in taxes that would have resulted if such amount had been included ratably over the taxable year and the four immediately preceding tax years.<sup>311</sup> If the distribution is less than \$2,500, the tax is 110% of the increase in tax which results from including the distribution in gross income for the taxable year in which the distribution was received.<sup>312</sup> As a further restriction upon any premature distribution, the taxable income is treated as not being less than the excess of the amount received over the number of personal exemptions to which the taxpayer is entitled in that taxable year.<sup>313</sup>

The scope of the penalty provisions on premature distributions includes not only outright payments to the owner-employee, but also loans against an annuity or life insurance contract<sup>314</sup> and assignments or pledges of any part of the owner-employee's interest in the plan.<sup>315</sup> As an additional penalty, the employer may not make further contributions to a qualified plan for any owner-employee for five taxable years after the year in which he receives a premature distribution.<sup>316</sup>

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304. I.R.C., § 105(g).

305. I.R.C., § 2517(b).

306. I.R.C., § 2039(c).

307. S. REP. No. 992, 87th Cong., 1st Sess. 24, 26 (1961).

308. I.R.C., § 37(c).

309. I.R.C., § 401(d)(4)(B).

310. I.R.C., § 72(m)(5).

311. I.R.C., § 72(m)(5)(B).

312. I.R.C., § 72(m)(5)(C).

313. I.R.C., § 72(n)(3).

314. I.R.C., § 72(m)(4)(B).

315. I.R.C., § 72(m)(4)(A).

316. I.R.C., § 401(d)(5)(C).

### G. Summary

It is readily apparent that the enactment of H.R. 10 has not removed the discrimination against the self-employed in regard to the establishment of qualified retirement plans; it has only decreased the discrimination. The limit on contributions for the benefit of owner-employees and the deduction permitted therefor by the employer clearly show that the self-employed have not attained equal status with shareholder-employees under a qualified corporate plan. Particularly in the case of a self-employed individual engaged in a trade or business where capital is a material income producing factor,<sup>317</sup> the individual desiring to establish a qualified retirement plan should seriously consider incorporation of his business and establishment of a qualified plan for regular employees (including shareholder-employees). Under a plan covering corporate shareholder-employees, the arbitrary 30% limitation on earned income is not applicable,<sup>318</sup> and the contributions on behalf of the owner as a stockholder-employee would ordinarily be substantially more than the amount permitted for an owner-employee.

Likewise, in the case of a partnership of professional men, the contributions and deductions permitted them under a qualified plan as owner-employees will probably be less than the contributions and deductions allowed them as employees of a professional association, assuming that such an association will be accorded the advantages presently enjoyed by qualified employees' plans. Also to be noted are the more liberal standards allowed an employees' plan regarding coverage and vesting of contributions.

### V. CONCLUSION

Notwithstanding the enactment of H. R. 10, the self-employed individual remains at a severe disadvantage as concerns deferred compensation. This is particularly true of the self-employed professional, for in many states the incorporation solution is still a vision for the future as to such persons. Furthermore, even in those states where statute or court rule permits professional incorporation, the problematical validity of such statutes and rules for federal tax purposes, not to mention the numerous tax difficulties encountered even if the desired corporate status is attained, makes the usefulness of such an approach questionable. Perhaps thoughtful

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317. I.R.C., § 401(c)(2)(B).

318. I.R.C., § 404(a).

drafting could eliminate some of the problems, but an approach which so deviates from long-established patterns will always encounter difficulties.

It seems rather obvious that the preferred solution lies in the area of direct Congressional action. It is unfortunate in this respect that H. R. 10 has accomplished so little; it is hardly likely that a great many self-employed professionals will find it of much use. The Congressional position, however, is understandable. The revenue loss to the Treasury was seriously considered by both houses of Congress.<sup>319</sup> If the self-employed group had been granted completely equal treatment, the revenue loss would indeed have been substantial. Insuring fairness in and the policing of myriads of small private plans was undoubtedly another key consideration.

Hopefully, however, the race is not yet completely run. The Senate minority report by Senators Douglas and Gore faces the fact that H. R. 10 is in all probability but a first step in the direction of tax equality for the self-employed.<sup>320</sup> In future years the self-employed will undoubtedly strive to liberalize the benefits of H. R. 10. It is quite possible that such attempts will prove successful.

Until such time as Congress sees fit to act further on the matter, many if not most self-employed professionals will probably continue as before. There will undoubtedly be an increase in legislation allowing professional incorporation, but it remains to be seen whether this will prove a completely feasible route. If the strict requirements of the "Kintner" Regulations are modified, the efficacy of the professional corporation or association may yet be established. But in view of the fact that the possibility of further Congressional action is probably more than mere wishful thinking, many professional partnerships and groups may prefer to delay action until the end result becomes clear.

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319. S. REP. No. 992, 87th Cong., 1st Sess. 10 (1961); H.R. No. 378, 87th Cong., 1st Sess. 5 (1961). For a background of Congressional thought on the matter, see Rapp, *The Quest for Tax Equality for Private Pension Plans: A Short History of the Jenkins-Keogh Bill*, 14 TAX L. REV. 55 (1958).

320. S. REP. No. 992, 87th Cong., 1st Sess. 64 (1961).