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The Professional Corporation: An Overview

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THE PROFESSIONAL CORPORATION: AN OVERVIEW

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I. INTRODUCTION

The purpose of this comment is to provide a newly formed, moderate-sized legal firm[1] or the beginning legal individual practitioner with a broad overview of the benefits and problems that a professional corporation [hereinafter PC] offers when compared to a partnership or individual proprietorship structure.[2] The emphasis here will be on the availability of in-depth material in the field along with the governing Internal Revenue Code and Treasury Regulations sections.

Acceptance of the principle that corporate structure should be available to professional practitioners is of relatively recent vintage.[3] The Treasury Department resisted the principle through promulgation of Regulations.[4] It was only after a series of losing efforts in the courts[5] that the Commissioner agreed to recognize such a structure for tax purposes,[6] provided that it was organized and operated under certain approved state statutes.[7]

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1. The problem is slightly more complex when converting an existing partnership into a professional corporation. *See generally* Eaton, *Operation of a Professional Service Corporation*, 28 N.Y.U. ANN. INST. ON FED. TAX. 1243 (1970).

2. The general statements of the comment are also adaptable to PC's for doctors, dentists, etc. *See* [1975] PROFESSIONAL CORPORATIONS HANDBOOK (CCH).

3. *See* Note, *The Latest Chapter in the Continuing Controversy Regarding Professional Service Corporations - The Roubik Case*, 19 KAN. L. REV. 348 (1971).

4. Treas. Reg. § 301.7701-1 *et seq.* (1960) T.D. 6503, 1960-2 C.B. 409.

5. Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969), *aff'g* 286 F. Supp. 839 (S.D. Fla. 1968); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969), *aff'g* 281 F. Supp. 359 (N.D. Ohio 1968); United States v. Empey, 406 F.2d 157 (10th Cir. 1969), *aff'g* 272 F. Supp. 851 (D. Colo. 1967).

6. Rev. Rul. 70-101, 1970-1 C.B. 278, *as amplified by* Rev. Rul. 70-455, 1970-2 C.B. 297.

7. *Id.*, the so-called "Kinter Regs." For Virginia the applicable sections of the Code are VA. CODE ANN. §§ 13.1-542 to -556 (Repl. Vol. 1973 & Cum. Supp. 1977). Merely following the state regulations will not be sufficient if the PC serves merely as a bookkeeping entity. Jerome J. Roubik, 53 T.C. 365 (1969). The IRS has published a new Ruling which says corporate status no longer depends on the Kinter Regs. Rev. Rul. 77-31, 1977-5 I.R.B. 18. This Ruling notes that incorporation under state law does not automatically qualify the PC for corporate tax treatment, although obviously, this is still a most important consideration. The

II. Tax Advantages

A. *Pension and Profit-Sharing Plans*

A potentially large tax savings occurs if the PC installs a pension and profit sharing plan.[8] Although the recent enactment of ERISA[9] at first clouded the picture of exactly what a qualified plan must contain,[10] under a properly qualified plan up to the lesser of 25% of an employee's compensation or $25,000 can be set aside tax free,[11] while only the lesser of 15% or $7,500 of earned income is available for individuals or partners.[12] This difference, although numerically great, is academic in a majority of instances. The professional who feels he can afford to set aside more than 15% of his income or more than $7,500 is certainly in the minority.

Distribution is vastly different under each situation. It was originally thought that under a Keogh plan any distribution prior to the age of 59 1/2 of the participant would be taxed as ordinary income plus a 10% penalty tax would be imposed.[13] In contrast, no penalty

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corporation must also earn the income as a separate legal entity. *See* Jerome J. Roubik, 53 T.C. 365 (1969).

8. I.R.C. § 401.

9. Employee Retirement Income Security Act of 1974, P.L. 93-406 (1974).

10. *See* Tilton and McNabb, *Complying with the IRS's New Guidlines for Determinations of Qualified Plans*, 44 J. Tax. 24 (1976).

11. I.R.C. § 415(c). These plans are now called "defined contribution" plans. ERISA § 3(34) (1974). It is possible to contribute a greater amount with the use of a defined benefit plan. I.R.C. § 415(b). Establishing a qualified plan is not a do-it-yourself project. The professional should consult with experts in the field to see that the plan meets the needs, funding abilities and expectations in every respect possible.

12. I.R.C. § 404(e)(1). Prior to 1962 the self-employed individual in a proprietorship or partnership had no way to accumulate retirement funds with pre-tax dollars. Upon the passage of the Self-Employed Individuals Tax Retirement Act of 1962, the so-called H.R. 10 or Keogh plan sponsored by Representative Eugene J. Keogh dealt with this problem. Under its original enactment a self-employed individual was allowed to set aside the lesser of $2,500 or 15% of earned income tax free and all accumulations of the fund are tax-free until distributed. *See* Rev. Proc. 72-7, 1972-1 C.B. 715. ERISA allows a self-employed individual to adopt a Keogh defined benefit plan that is the same as a corporate plan but the Keogh accurals must be reduced for death benefits or other ancillary benefits including disability benefits. I.R.C. § 401(j). *See* Zalutsky, *Comparison of a Professional Corporation With an Unincorporated Practice After ERISA*, 34 N.Y.U. Ann. Inst. on Fed. Tax. 1355 (1976) [hereinafter cited as Zalutsky].

13. I.R.C. § 401(d)(5)(C), § 72(m)(5)(A)(i), § 72(m)(5)(B). At the end of 1976 some banks were refusing to make any premature distribution of Keogh funds. *See* Richmond Times Dispatch, Dec. 28, 1976, at A-9.

tax is imposed on premature distributions of a corporate plan.[14] There is also an estate tax advantage to the PC plan since the amount contributed by the PC employer is not included in the gross estate of the deceased employee unless it is paid to the estate or personal representative[15] and provided it is not paid out as a lump sum.[16] In addition, if the professional dies before a complete distribution of his interest in the plan has been made, under a PC plan the first $5,000 distributed to his beneficiaries will not be subject to an income tax.[17]

The combination of the greater amount which can be set aside tax free under a PC plan, plus the withdrawal and death benefit advantages alone is sufficient reason for most professionals to use a corporate structure.[18]

B. *Group Term Life Insurance*

For the professional who utilizes life insurance in his estate plan, the PC can take advantage of the provision which allows a business deduction for premiums on group term life insurance up to a maximum of $50,000 face value.[19] By using the pre-tax dollars of the corporation to pay the premium, the professional can in effect have the government pay a portion of his insurance costs.[20] This advantage is not available to the self-employed professional.[21]

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14. Treas. Reg. 1.401-1(b)(1)(ii)(1972). *See also* Zalutsky, *supra* note 12, at 1374.

15. I.R.C. § 2039(c). Distribution from a Keogh plan will be included in the gross estate. *Id.*

16. *Id.* Under prior law, lump sum distributions from qualified pension and profit-sharing plans generally were excludable to the extent they were attributable to employer contributions.

17. I.R.C. § 101(b)(2)(B)(i). Under a Keogh plan this exclusion is not available.

18. For a concise analysis of other advantages available in a corporate plan *see* Shores, *Professional Corporations*, 10 WAKE FOREST L. REV. 691 (1974).

19. I.R.C. § 79. The amount of the premium is not taxable to the employee as gross income. I.R.C. § 101.

20. The premium for a 35 year-old professional for a $50,000 group term policy is approximately $125.00. Thus assuming a 50% personal tax bracket the savings amounts to $62.50. If the professional irrevocably transfers all incidences of ownership of the policy to a third person, the proceeds upon his death will not be included in his gross estate. I.R.C. § 2042.

21. The group term insurance cannot be limited solely to shareholder-employees. Treas. Reg. § 1.79-1(b)(1)(iii)(b) (1972).

C. *Health and Accident Insurance*

Within a PC, a professional can provide for himself[22] unlimited health and accident insurance coverage without the cost of that coverage being included in the professional's gross income.[23] As with the group term life insurance, this protection must be paid for with after-tax dollars by a self-employed professional.[24]

D. *Medical Reimbursement Plans*

The PC can also adopt, by board resolution, a plan to reimburse employees[25] for any medical expense as defined by the Code[26] incurred by the employee or his family, and such reimbursement is not included in the employee's gross income except to the extent that it exceeds the actual expenses incurred.[27] This savings is not available to the self-employed professional except as an itemized class B deduction.[28]

E. *Wage Continuation Plans*

The PC may also adopt a plan which will continue paying the wages of employees who are ill or disabled.[29] Such a plan may be provided through insurance coverage, and the premium will be deductible by the corporation.[30]

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22. There is still some doubt whether all employees of the corporation must be covered. *See* [1975] PROFESSIONAL CORPORATIONS HANDBOOK (CCH) at 2680.

23. I.R.C. § 106. Treas. Reg. § 1.162-10(a)(1958).

24. I.R.C. § 213(a)(2).

25. I.R.C. § 105(b). These plans are probably subject to the same limitations as Health and Accident Plans. *See* note 22 *supra*. However, the reimbursement can be structured as a percentage of salary. Since the professional employees will have much larger salaries than the non-professional employees, the bulk of the benefit will flow to the employee-owners.

26. I.R.C. § 213(e)(1).

27. Treas. Reg. 1.105-2 (1956).

28. I.R.C. § 213(a). If the taxpayer itemizes his deductions, medical expenses are deductible to the extent that they exceed 3% of the taxpayer's adjusted gross income plus one-half of the medical insurance premium paid or $150.

29. The amount paid to the employee received certain income tax exclusions prior to the passage of the Tax Reform Act of 1976. I.R.C. § 105(d)(1), *struck out by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 505, 90 Stat. 1566 (1976). The effective date of this deletion provision has been postponed until after tax years beginning after 1976 by the Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 301, 91 Stat. 151 (1977).

30. Treas. Reg. 1.162-10 (1958). Disability income is of great concern to most professionals and can be provided through an insurance program. The PC can pay the premiums for the

F. *Key Man Insurance*

Although the premiums payed by a PC for key man insurance, which will provide the corporation with the necessary funds to redeem a deceased shareholder's interest in the corporation, are not deductible,[31] the premiums will be paid subject only to the corporate tax rate instead of the professional's individual tax rate if he is practicing alone or as a partner.[32]

III. INCREASED COSTS

There are certain costs which increase under the PC structure when compared with proprietorship or partnership operations. Social Security payments[33] must be paid by the corporation and by the employee.[34] Also, federal unemployment insurance must be paid by the PC which is not paid by the self-employed professional.[35]

Also, such costs which normally attach to the corporate form of doing business must be considered. These would include: annual corporate franchise taxes,[36] incorporation fees,[37] legal fees, if the incorporation is not handled by the professional shareholder,[38] and the possibility of management fees for the profit and pension trust funds. These increases are usually not considered sufficient to offset the greater savings which are available to a PC.

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disability insurance and deduct those payments as an ordinary and necessary business expense without the premiums being taxed as income to the employee. I.R.C. §§ 106, 162. Subject to the possibility of a sickpay exclusion, *see* note 29 *supra*, the benefits payable under such insurance coverage will be taxable income to the employee. I.R.C. §§ 61, 104(a)(3). Disability insurance premiums payed by an individual are not deductible.

31. Nor are the proceeds taxable as gross income. I.R.C. § 101(a).

32. The corporate tax rate is 20% for the first $25,000 of taxable income; 22% of the next $25,000; and 48% of all taxable income that exceeds $50,000. I.R.C. § 11.

33. Old Age, Survivors, and Disability Insurance Tax and Hospital Insurance Tax. I.R.C. § 3101.

34. 5.85% of the first $16,500 of compensation effective January 1, 1977 is paid by the employee and matched by the employer. The employer's (the PC's) share is a deductible business expense. I.R.C. § 162. A self-employed professional must pay 7.9% of the first $16,500 of net income as a self-employment tax. I.R.C. § 1401.

35. I.R.C. § 3301. The rate is 3.2% of the first $4,100 of wages reduced by any state unemployment tax paid up to a maximum of 2.7% credit for such payments. I.R.C. § 3302.

36. *See, e.g.*, VA. CODE ANN. § 58-456 (Cum. Supp. 1977).

37. *See, e.g.*, VA. CODE ANN. § 58-442 (Repl. Vol. 1974).

38. Both the incorporation fees and the legal fees may be amortized over no less than a five year period.

IV. NON-TAX CONSIDERATIONS

The possibility of tax savings is usually the paramount reason a professional chooses the corporate structure; there are, however, several important non-tax advantages as well. The first, and perhaps most important, is that of limited liability. While the professional still remains liable for his own torts[39] and possibly the torts of those persons under his supervision and control,[40] it is generally agreed that he escapes the joint and severable liability imposed upon him for torts committed by his professional associates within a partnership form of business.[41]

Continuity of existence offers another advantage over a partnership or proprietorship form of practice. Upon the death or other withdrawal of a partner, a partnership automatically ceases.[42] However, the life of the corporation does not cease except upon the happening of some event provided for in the enabling statutes of its state.[43]

As the PC grows and adds more shareholder-employees, the concept of centralized management, with direction of the organization vested in its board of directors and the day-to-day operations delegated to its officers, offers a decided advantage over the large partnership where each partner has an equal voice in its management.[44]

The corporate structure advantage of free transferability of ownership is usually limited by statute to persons who are licensed to practice in the field.[45] This will probably be further limited by the corporate by-laws allowing first right of refusal on the part of the remaining shareholders in the corporation preventing the admittance into the organization of someone who might not be compatible with those remaining shareholders.

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39. *See, e.g.*, VA. CODE ANN. § 13.1-547 (Repl. Vol. 1973).

40. *See, e.g.*, IDAHO CODE § 30-1406 (1967).

41. UNIFORM PARTNERSHIP ACT; 7 U.L.A. § 15. However, various state laws limit this liability for professional associates in the same manner as for a PC. *See, e.g.*, VA. CODE ANN. § 54-886 (Repl. Vol. 1974).

42. The partnership may continue in existence for tax purposes until the interest of the withdrawing partner has been paid out. I.R.C. § 736.

43. *See, e.g.*, VA. CODE ANN. §§ 13.1-551, -552 (Repl. Vol. 1973).

44. *See generally* J. Crane and A. Bromberg, LAW OF PARTNERSHIP (1968).

45. *See, e.g.*, VA. CODE ANN. § 13.1-550 (Repl. Vol. 1973).

V. Possible Pitfalls

A. *Incorporating the PC*

If the principals contemplating the formation of a PC already have an established practice either as an individual proprietorship or as a partnership, the formation of a PC as their operating entity can have serious tax consequences. It is possible to incorporate under the existing tax laws without incurring any tax liability.[46] Attorneys usually report income on a cash basis, and it is this feature of their practice which creates the possible pitfall.

When the entire interests of the former practice are transferred to the new PC in exchange for the stock of the PC, the assets and liabilities are generally of three classes: accounts receivable, equipment and fixtures, and accounts payable. Because the accounts receivable have not been taken into income of a cash basis taxpayer, they have a basis of zero. Therefore, if the transferred accounts payable liabilities exceed the adjusted basis of the equipment and fixtures, the amount of that excess is taxable as ordinary income.[47]

In addition to this pitfall, the basis of the PC stock in the hands of the shareholder-transferree may be very small and create tax consequences when it is sold or otherwise disposed of.[48]

It is possible to avoid these tax consequences by using one of several methods,[49] and the thrust of this article is to point out that

46. I.R.C. § 351(a) which provides that when property is transferred to a corporation solely in exchange for its stock or securities, no gain or loss is recognized if the transferor has 80% control after the transaction.

47. I.R.C. § 357(c). An example would be a taxpayer that has $20,000 accounts receivable, $15,000 accounts payable and $20,000 of equipment and fixtures with an adjusted basis of $10,000. The liabilities of $15,000 exceed the assets of $10,000 ($20,000 cost-$10,000 depreciation) by $5,000 which is classified as boot and must be taken into income as ordinary income. *Id.*

48. Using the same figures as in note 47 *supra*, the taxpayer's basis for the PC stock would be $10,000 (the basis of the equipment and fixtures) minus $15,000 (the accounts payable) plus $5,000 (the gain recognized) or zero. I.R.C. § 358(a).

49. One solution is to withhold from the transfer a sufficient amount of accounts receivable with which to liquidate the accounts payable. This necessitates a dual bookkeeping system. A second solution is to change the taxpayer's accounting method from a cash to an accrual one. This requires approval from the Commissioner. A third solution is to create an agreement with the PC whereby the PC acts as agent for the taxpayer to collect the accounts receivable and pay off the accounts payable. *See* Doggett v. Comm'r, 275 F.2d 823 (4th Cir. 1960).

careful planning is necessary when converting an established practice into a PC if the transaction is to be a tax-free one.

B. *Unreasonable Accumulations*

The PC, like any other corporation, is subject to the accumulated earnings tax[50] for the excess over $150,000 of accumulated past and present earnings of the corporation.[51] As there is little need for accumulation of earnings within a PC unless it seeks to provide its own funds for stock redemption or contingent malpractice liabilities through self-insurance, the problem generally will not arise.

C. *Unreasonable Compensation*

Since most PC's require only small amounts of investment funds to begin the business,[52] and the income is almost entirely due to the professional services rendered by the shareholder employees, the question of unreasonable compensation will also probably not arise. The goal of most PC's is to pass earnings to the owner-professionals in the form of salary and avoid the use of dividends which would be doubly taxed, first to the corporation as income and second to the shareholder when paid out as a dividend. To do this the PC will generally use a combination of fixed salary plus some bonus arrangement to reduce the PC's net earnings as far as the need for future capital will allow. Meeting this goal can possibly raise the spectre of whether the professional salaries are reasonable. An accurate record of the effort in time and unique nature of the services provided by the employees will provide a foundation for determining and proving the reasonableness of compensation. If this is coupled with at least some dividend payments to shareholders[53] and perhaps an agreement between the employees and the corporation

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50. I.R.C. §§ 532(a), 533(a), 535(c)(1), 537. Treas. Reg. § 1.533.1 (1963).

51. I.R.C. § 535(c)(2), *as amended by* Tax Reduction Act of 1975, Pub. L. No. 94-12, § 304(a), 89 Stat. 45 (1975).

52. One possible exception might be a medical PC requiring extensive and expensive equipment or any PC which decides to purchase the building in which it practices. This can best be avoided by forming a separate corporation or partnership to own the realty and/or equipment with a lease-back arrangement for the PC.

53. It will be beneficial to keep the original investment of each shareholder to a minimum so that dividends, subject to double taxation, can be reasonably paid and still not be a burden upon the shareholder-employees.

to return any salary determined to be unreasonable,[54] the unreasonable compensation problem can be diminished, if not entirely eliminated.

D. *Personal Holding Company*

The PC must be careful to avoid having the Service designate it as a personal holding company, since there is a 70% penalty tax on the undistributed income of such a company.[55] If there are over five shareholders[56] or the shareholders have elected subchapter S[57] designation, the PC falls outside the personal holding company designation. If neither of these methods is desirable or practical, then care should be taken to provide within the by-laws of the PC or its employment agreements that only the board of directors of the PC has the power to assign work among the PC's employees.[58]

E. *Subchapter S*

If there are ten or less shareholders, the PC may elect subchapter S status.[59] This will eliminate any problems which might arise as to unreasonable accumulations,[60] reasonableness of compensation,[61] double tax on dividends,[62] and personal holding company income.[63] In as much as all of the income of the corporation is passed through and taxed at each shareholder's individual rate,[64] a higher tax will probably be paid on those funds retained in the PC for expansion purposes.[65]

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54. I.R.C. § 1341(a); Treas. Reg. § 1.1341.1-1 (1957). *See* Streckfus Steamers, Inc., 19 T.C. 1 (1952); *cf.* Cooke v. Comm'r, 203 F.2d 258 (10th Cir.), *cert. denied,* 346 U.S. 815 (1953). See Rev. Rul. 69-115, 1969-1 C.B. 50 for a model board of directors resolution providing for such a repayment.
55. I.R.C. §§ 541 to 547.
56. I.R.C. § 542(a)(2).
57. I.R.C. §§ 1371 to 1379.
58. I.R.C. § 543(a)(7)(A).
59. I.R.C. § 1371(a)(1).
60. I.R.C. § 1373.
61. *Id.*
62. *Id.*
63. *See* notes 55-58 *supra,* and accompanying text.
64. I.R.C. § 1373.
65. *See* note 32 *supra,* and accompanying text.

F. *Section 1244 Stock*

It is unlikely that any PC will prove unprofitable. However, the possibility that this might occur should be sufficient reason to have the minutes of the PC contain a proper Section 1244 plan.[66]

VI. SUMMARY

The PC can provide many advantages both in tax savings and other business considerations.[67] Every professional should examine its benefits carefully to determine if a PC meets his needs and expectations.

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66. I.R.C. § 1244. This converts what would normally be a capital loss into an ordinary income loss. *See* Comment, *Section 1244 Small Business Stock-Professional Responsibility Demands Its Use*, 10 U. RICH. L. REV. 355 (1976).

67. This opinion is not unanimous. Some writers feel that the difference between an unincorporated individual and one who opts for the PC is not so great as to warrant the move into a PC. *See* Kalish & Lewis, *Professional Corporations Revisited (After the Employer Retirement Income Security Act of 1974)*, 28 TAX LAW. 471 (1975). *But see* Siegel, *The Utility of the Professional Corporation: A Rejoinder*, 29 TAX LAW. 265 (1976).