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ARTICLES

EVOLUTION TO EXTINCTION? THE PROFESSIONAL CORPORATION AFTER TEFRA

Steven R. Hirschtick
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INTRODUCTION

In recent years the corporate form has been increasingly used by professionals and other highly compensated individuals such as athletes and entertainers to obtain federal income tax benefits unavailable to sole proprietors or partners. The incentive for this type of planning is the difference that exists in the Internal Revenue Code¹ in tax benefits, primarily retirement benefits, available to employees versus self-employed individuals. The Code establishes very favorable benefits for qualified retirement plans such as Individual Retirement Accounts,² Keogh plans and corporate plans for employees. The tax benefits available to all of these plans include current deductions for contributions with a deferral of taxation of the participant until subsequent receipt³ and the accumulation of earnings in the plans without a current tax bite.⁴ Corporate plans have, however, been favored by professionals and similarly situated individuals because of the significantly greater amounts which could be sheltered from taxes.

Following the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"),⁵ for example, the maximum annual addition for a participant in a corporate defined contribution plan was \$25,000,⁶ whereas a Keogh plan participant was limited to a ceiling of \$7,500,⁷ and Individual Retirement Accounts were limited to \$1,500.⁸

1. Int. Rev. Code of 1954, as amended (*hereinafter* "I.R.C.").

2. I.R.C. § 408.

3. I.R.C. § 401, 404.

4. I.R.C. § 501(a).

5. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

6. I.R.C. § 415(c).

7. I.R.C. § 404(e)(1).

8. I.R.C. §§ 408(b), 219.

Furthermore, there were other less significant, but nevertheless favorable, attributes of corporate plans only.⁹

The self-employed highly compensated individual's only retirement and current tax shelter plan choices are a Keogh plan or Individual Retirement Account.¹⁰ These choices are, however, expanded to include corporate plans if the individual forms a corporation and then obtains employee status through being hired by the corporation. Furthermore, there are other tax benefits, although not as significant as retirement plans, available only in the corporate form.¹¹ Changing to employee status to obtain the attendant tax benefits was the sole reason behind the formation of most professional corporations.¹² This planning has recently gone to the extreme of partnerships of individual corporations, thus allowing each professional to individually tailor the retirement benefits and avoid providing these benefits to non-professionals in the group.¹³

This type of creative tax planning for professionals and similarly situated individuals has been dramatically altered by the recently enacted Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").¹⁴ This article will detail the brief and colorful history of the professional corporation, discuss the provisions of TEFRA relevant to this type of planning, and explore the planning potentials left in the wake of TEFRA.

HISTORY OF THE PROFESSIONAL CORPORATION

The provisions of TEFRA applicable to professional corporations and similar structures utilized by athletes and entertainers represent the most recent salvo in the battled waged by the Internal Revenue Service. An examination of the history of this planning vehicle, as shown by the

9. A corporate retirement plan participant may, for example, borrow from a corporate retirement plan, (I.R.C. § 4975(d)(1)), although this has been somewhat limited by § 236 of the Tax Equity and Fiscal Responsibility Act of 1982, which added subsection (p)(2) to I.R.C. § 72.

10. Corporate retirement plan benefits are available only to employees, and sole proprietors and partners are not considered to be employees.

11. *E.g.*, accident and health plans, (I.R.C. § 105); employees' death benefits, (I.R.C. § 101(b)); and the deferral potential available from a corporate fiscal year rather than a calendar year. Treas. Reg. § 1.441-1(b)(3) (1960). *See also* [1982] 1 PROF. CORP. HANDBOOK (CCH) pp. 131-134.

12. [1977] 1 PROF. CORP. HANDBOOK (CCH) p. 115.

13. *Kiddie v. Commissioner*, 69 T.C. 1055 (1978); *Garland v. Commissioner*, 73 T.C. 5 (1979). *See infra* pp. 109-111.

14. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

history of professional corporations, discloses a battle between the Service and the individual taxpayer seeking to obtain and maximize the tax benefits of the corporate form.

Ironically, it was the Internal Revenue Service that planted the conceptual seed which sprouted into today's professional corporations. This seed was planted in *Morrissey v. Commissioner*,¹⁵ in which the Supreme Court confirmed the concept that an unincorporated entity could, in certain settings, be treated as a corporation for income tax purposes.

Morrissey involved a trust which was established for the development of a golf course. The Court stated that an enterprise for the transaction of business is not the characteristic of an ordinary trust. In confirming the so-called "corporate resemblance" test, the Court held that the trust constituted an association which would be taxed as a corporation. The Court identified the following features which made the trust analogous to a corporation:

1. An association created for carrying on a business enterprise and sharing in its gains;
2. Centralized management assigned to the trustees;
3. Transferrable beneficial interests;
4. Continuity of the enterprise upon death of the owners; and
5. Limited personal liability of the owners.¹⁶

The Supreme Court in *Morrissey* thus provided the conceptual stepping-stone for professionals who sought corporate tax benefits but had been denied the ability to achieve corporate status under state law. Members of professions who were experiencing increasingly higher income taxes desired the tax benefits resulting from pension and profit-sharing plans, and other benefits which were available only to "employees." They thus began forming associations for the practice of their professions, classified and treated themselves as employees of their association and took the tax benefits available to that status. By including in their articles of association the corporate attributes established by *Morrissey*, the professionals sought to attain classification as corporations for tax purposes.

The Treasury Department, taking an antagonistic turn, changed its

15. 296 U.S. 344 (1935).

16. The existence of a corporate charter or Articles of Incorporation is not the key to being taxed as a corporation under the Internal Revenue Code; rather, this treatment depends upon the codified "resemblance test." Treas. Reg. § 301.7701-1 (1967).

position with regard to tax treatment of these organizations. The Department asserted that these professional associations should be regarded as partnerships for federal income tax purposes and were not entitled to the tax benefits they sought to attain.¹⁷

This new position was tested in the landmark case of *United States v. Kintner*.¹⁸ In *Kintner*, the taxpayer doctor and seven other physicians executed articles of association for the practice of medicine, thus reorganizing a previous partnership. The articles included some of the *Morrissey* criteria (i.e., continuity of life, a centralized management consisting of 5 executive committee members, business purpose, net earnings were divided among members, and partial limitation of liability). The Court held that the association more nearly resembled a corporation than a partnership and should be taxed as a corporation.¹⁹ Although under state law physicians were prohibited from practicing medicine in the corporate form, the Court stated that classification for federal tax purposes was a question of federal, not state, law.²⁰

In 1960, after numerous similar defeats, the Treasury Department responded to this judicial non-acceptance of its position by promulgating regulations which indirectly overturned the *Kintner* decision.²¹ These became known as the *Kintner* regulations because the purpose behind them was obvious. The regulations were aimed at making it impossible for unincorporated professional organizations to achieve corporate status for federal income tax purposes. General tests were set forth for determining conditions under which an association would be considered to have the characteristics of a corporation. Fortunately for

17. While in *Morrissey* the Government argued in favor of taxing the trust as a corporation because it engaged in business as an association, the Government turned full circle with regard to professionals. The Government took the position that if, under local law, professionals were not allowed to incorporate, then they could not be classified as associations for income tax purposes regardless of their corporate characteristics. *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

18. 216 F.2d 418 (9th Cir. 1954).

19. "It is obvious from this record that petitioners' enterprise was carried on for profit, and it is likewise clear that all the substantial points of resemblance to a corporation as specified in the decisions mentioned were present in their organization. On the other hand, substantial dissimilarities to the partnership form appear." *U.S. v. Kintner*, 216 F.2d 418, 422 (9th Cir. 1954), quoting *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936).

20. "[I]t would introduce an anarchic element in federal taxation if we determined the nature of associations by state criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system,—a uniformity which calls for equal treatment of taxpayers, no matter in what state their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the state of residence." *U.S. v. Kintner*, 216 F.2d 418, 424 (9th Cir. 1954).

21. *Treas. Reg.* §§ 301.7701-1 and 301.7701-2; T.D. 6503, 1960-2 C.B. 409.

the professionals, the door was still open for states to enact legislation enabling professionals to practice as corporations thus circumventing the impact of the *Kintner* regulations.

Taxpayers did turn to the state legislatures for assistance in achieving corporate status. Many states responded by enacting statutes that satisfied the 1960 regulations and permitted doctors, lawyers and other professionals to form corporations for the practice of their specialties.²² By 1970, forty-nine states had enacted such statutes.

Predictably, the IRS retaliated in 1965 by amending the 1960 regulations. The amendments required that the *Morrissey* resemblance test be met by professional corporations regardless of state law.²³ These standards were virtually impossible to meet,²⁴ so the taxpayers again took the IRS to court.

In *U.S. v. Empey*,²⁵ the Appellate Court unanimously agreed that the 1965 amendments were invalid. In *Empey*, the court held that in taxing a professional association of lawyers as a partnership under the 1965 amendment, the IRS was being "unreasonable and inconsistent with statutory definitions of 'partnership' and 'corporation'." The IRS's undertaking to overturn these definitions in its regulations constituted "an attempt to legislate" and was therefore invalid.²⁶

Empey was the first in a string of defeats for the IRS and its 1965 amendments.²⁷ In each case, the amendments were held invalid and the organization in question was held to be a corporation for federal income tax purposes.

The only victory for the IRS was in *Roubik v. Commissioner*.²⁸ In that case, the Tax Court held that the professional corporation would not be taxed as a corporation because it was a mere "skeleton." The

22. See, e.g., CAL. CORP. CODE § 13400 et seq., cited as "Moscone-Knox Professional Corporations Act," CONSOLIDATED LAW OF NEW YORK, Ch. 4, Art. 15, §§ 1501-1515; ILL. REV. STATUTES, Ch. 32, § 415-1 et seq.

23. T.D. 6797, February 3, 1965, §§ 301.7701-1 to 301.7701-3.

24. The amended regulations required different standards for personal service organizations than for other corporations when determining tax treatment. While an organization needed only to more nearly resemble a corporation than a partnership or trust to be taxed as a corporation, (Treas. Reg. § 301.77012-2 (1960)), a personal service organization had much stricter standards to meet. As stated by the 10th Circuit Court of Appeals in *Empey*, "it is fairly obvious that the purpose of the amendments of January 28, 1965, was to prevent a professional service organization from being able to qualify as a corporation for tax purposes under the Internal Revenue Code."

25. 406 F.2d 157 (10th Cir. 1969).

26. *U.S. v. Empey*, 406 F.2d at 170.

27. See, e.g., *Kurzner v. U.S.*, 413 F.2d 97 (5th Cir. 1969); *O'Neill v. U.S.*, 410 F.2d 888 (6th Cir. 1969); *Van Epps v. U.S.*, 301 F. Supp. 256 (D. Ariz. 1969).

28. 53 T.C. 365 (1969).

corporation had no control over its "employees" who were merely engaged in separate practice with centralized "corporate" bookkeeping. *Roubik* is a classic blueprint of how not to operate a professional corporation.

In 1969, the IRS finally conceded that professional organizations formed under state incorporation laws would be taxed as corporations for federal income tax purposes.²⁹ The reluctance on the part of government to concede to the professional taxpayers clearly echoes much of the motivation behind certain provisions of TEFRA. This sentiment was epitomized in the case of *Dean P. Epperson*³⁰ where a doctor practicing as a professional corporation sought review of a lower court ruling based on prejudicial error. The trial court had upheld the corporate status but also held that certain payments to the doctor were taxable as dividend income and not loans. The error in question on appeal concerned the closing argument by counsel for the Government. He said, among other things:

We see no reason why a man who has as much money as Dr. Epperson, who has more money than he can probably ever spend, is entitled to ignore all the rules that everybody else has to live by. . . . We say he is not entitled to a refund of taxes because he hasn't paid his fair share Let's make this doctor pay the kind of income taxes he ought to pay I am sick and tired, and I know you are, at having to pay taxes at a rate when these rich people like to construe and set up all these transactions to save taxes so they don't have to pay any.³¹

The Court of Appeals felt that although these words were in "bad taste," they were not prejudicial to Dr. Epperson.

So in 1969, the Service accepted the concept of incorporated professionals and, as in *Roubik* and *Epperson*, challenged only the utilization of this form, rather than the form itself. As the IRS accepted the corporate form for professionals, many of the professionals then attempted to maximize the benefits of this form for themselves. The area of controversy thus became discrimination in the qualified retirement plans. As mentioned, the motivation for professionals and similarly situated individuals to incorporate was the utilization of corporate, as

29. Rev. Rul. 70-101, 1970-1 C.B. 278, as subsequently amplified by Rev. Rul. 70-455, 1970-2 C.B. 297; Rev. Rul. 72-468, 1972-2 C.B. 647; Rev. Rul. 73-596, 1973-2 C.B. 424; and Rev. Rul. 74-439, 1974-2 C.B. 405.

30. 490 F.2d 98 (7th Cir. 1973).

31. *Id.* at 100.

opposed to IRA or Keogh, retirement plans. These corporate retirement plans received favorable tax treatment only if they were qualified under the applicable provisions of the Internal Revenue Code.³² Qualified status in large part depends upon compliance with the antidiscrimination and coverage rules.³³ The impact of the rules upon an incorporated professional requires retirement plan coverage of most, if not all, full-time non-professional employees of the corporation. Full-time is liberally defined for these purposes as working or being paid for 1,000 or more hours during a twelve-month period or an average of approximately 19 hours per week.³⁴ Retirement plan coverage of the non-professional corporate employees had the obvious effect of increasing the cost to the professional of the corporate form, thus making this form far less attractive to many professionals. Some professionals attempted to avoid this cost impact through what they and their advisors undoubtedly considered creative compliance with the antidiscrimination rules. *Revenue Ruling 73-477*,³⁵ for example, deals with an attempt to share part-time employees rather than using full-time employees who would have to be covered under a qualified retirement plan. The ruling's fact situation involved two professional corporations which had separate medical practices but shared office facilities and the professional services of two nurses. Each nurse worked as a part-time employee for each corporation, but their total combined hours of work per week was enough to be classified as a full-time employee for retirement plan purposes. As a most effective solution to this attempt to avoid retirement plan coverage of the nurses, the IRS ruled that both of the nurses were full-time employees of each professional corporation.

The Service and the Department of the Treasury were quick to move to a legislative solution when judicial or administrative measures did not stop what the IRS considered an abuse of the antidiscrimination rules. Employee leasing from a related corporation is an example of such an "abuse." This concept involved the formation of two corporations by the professional. One corporation was established to conduct the professional activity, and hired the licensed professionals as its only employees. The other corporation ("service corporation") was not established as a professional corporation, and hired the non-professional support personnel as its employees. The professionals owned the controlling interests of each corporation. The professional corporation

32. I.R.C. §§ 401-415.

33. I.R.C. §§ 401(a)(4), (5), 410(b), *see also, e.g.*, Rev. Rul. 70-183, 1970-1 C.B. 103.

34. I.R.C. §§ 401(d)(3)(A), 410(a)(3).

35. 1973-2 C.B. 135.

then contracted with the service corporation to retain the services of its employees. As one might expect when reviewing this type of planning, the professional corporation adopted very generous retirement plans while the service corporation adopted sparse plans or none at all. The professionals and other similarly situated individuals were thus able to obtain all of the tax and financial benefits of incorporation and corporate qualified retirement plans without incurring the cost of providing the same benefits to people who were, in truth, their employees.

The Service's response to employee leasing from a controlled corporation was to seek and obtain a legislative solution. Congress, as part of the Employee Retirement Income Security Act of 1974 ("ERISA"), added Sections 414(b) and (c) to the Internal Revenue Code.³⁶ Under these subsections, the employees of a controlled group of corporations,³⁷ such as commonly owned professional and service corporations, will be treated as if employed by one employer for purposes of the coverage and antidiscrimination rules applicable to qualified retirement plans. The Congressional intent behind these subsections was clearly stated:

The [House Ways and Means] committee, by this provision, intends to make it clear that the coverage and antidiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation. For example, if managerial functions were performed through one corporation employing highly compensated personnel, which has a generous pension plan, and assembly-line functions were performed through one or more other corporations employing lower-paid employees, which have less generous plans, or no plans at all, this would generally constitute an impermissible discrimination.³⁸

This avenue of creative, and to some abusive, tax planning was thus foreclosed to the incorporated professional. The unrelated employees leasing industry, however, received a real boost from these developments. When leasing employees from an unrelated company, the professional transfers, on paper, his or her employees to the leasing company, and these employees are then leased back to the professional. Compensation and benefits are paid by the leasing company. The benefits for these employees were often substantially less than the benefits

36. ERISA § 1015.

37. See Dunkle, *Tax Court's Reading of 414(b) Endangers Controlled Group's Plans*, 56 J. TAX'N. 8 (1982).

38. CCH, PENSION REFORM ACT OF 1974, LAW AND EXPLANATION 39 (1974).

provided to the employees of the professional corporation and thus a significant cost savings was achieved. The impact of Sections 414(b) and (c) was avoided because the leasing company and professional corporation were not related in an ownership sense. Internal Revenue Service action and certain provisions of TEFRA, however, have taken most of the attractiveness out of this type of planning.³⁹

After the I.R.S. foreclosed employee sharing by *Rev. Rul. 73-447* and Congress inhibited employee leasing from a related corporation by the addition of Sections 414(b) and (c) to the Code, the professionals' next tactic involved a slight variation of these concepts which was successful in winding its way through IRS challenges in Tax Court. The professionals formed partnerships of professional corporations or individuals and professional corporations.⁴⁰ Each principal or professional who was a partner had a choice of occupying this capacity as an individual or forming a corporation and plugging the corporation into his or her slot as a partner in the partnership. Each corporation would have only one employee, the professional, and adopt whatever qualified retirement plans best suited that individual. The non-partners in the structure were treated as employees of the partnership, and no provision was thereby made for them under the corporate partner's retirement plans. The IRS was twice unsuccessful in challenging this planning in Tax Court.⁴¹

The first challenge was raised in *Thomas Kiddie, M.D., Inc. v. Commissioner*.⁴² In this case, Dr. Kiddie formed a professional medical corporation in 1978 to provide pathological services to a hospital. He then joined with another professional medical corporation to form a partnership to provide medical services. Four additional doctors were employed by the partnership and each corporation was a fifty percent partner.

Dr. Kiddie's professional corporation adopted a defined benefit plan which covered Dr. Kiddie as the sole corporate employee, without covering any of the partnership employees. The IRS attacked the plan as discriminatory, asserting a substance-over-form argument that the partnership employees were actually employed by the professional corporate partners for purposes of the antidiscrimination and coverage rules. The Tax Court rejected this argument and held that the employ-

39. TEFRA § 248, adding subsection (n) to I.R.C. § 414.

40. *Kiddie v. Commissioner*, 69 T.C. 1055 (1978); *Garland v. Commissioner*, 73 T.C. 5 (1979).

41. *Id.*

42. 69 T.C. 1055 (1978).

ees were partnership employees and thus properly excluded from the corporate retirement plan. Dr. Kiddie's professional corporation never owned more than fifty percent of the partnership and therefore was never in control of the partnership. It was this absence of control that prevented the allocation of the partnership employees to the corporate partners for purposes of the retirement plan qualification rules.⁴³

The Service was not content to accept the *Kiddie* decision, and a year later, resurrected the same issues before the Tax Court in *Lloyd M. Garland, M.D., F.A.C.S., P.A. v. Commissioner*.⁴⁴ Dr. Garland had dissolved his partnership of individuals with another doctor, formed a professional corporation, and his corporation formed a new partnership with the previous partner. Dr. Garland was the sole employee of the professional corporation. The corporation adopted qualified retirement plans which, following their amendment to comply with ERISA, covered only Dr. Garland and no employees of the partnership. Recognizing these facts as virtually identical to those in *Kiddie*, the Tax Court stated:

[The Government] asks us to overrule our opinion in *Kiddie, supra*, and hold that the employment relationship between the partnership and its employees must be attributed to each notwithstanding the possibility that his interest in partnership profits or capital may not exceed fifty percent. We agree with [Dr. Garland's professional corporation].⁴⁵

Furthermore, in holding for Dr. Garland's professional corporation, the Tax Court also stated its opinion that Sections 414(b) and (c) of the Code added by ERISA are the exclusive means for aggregating employees of related business entities for the purpose of applying the antidiscrimination rules. Thus faced with a judicial refusal to close what it considered a gaping loophole, the Service again sought and obtained a legislative solution.

Congress added Section 414(m) to the Code as part of the Miscel-

43. "Generally, attribution of partnership characteristics to a partner does not occur unless that partner controls the partnership. Although there is no universal definition, section 707(b) of subchapter K defines such control. . . . [A] partner owning more than a 50 percent interest may not recognize a loss which arose in dealings between such partner and the partnership. . . ."

"We find the greater than 50 percent interest test . . . to be equally applicable in defining control of a partnership for purposes of Section 401(a)(3)." *Kiddie v. Commissioner*, 69 T.C. 1055, 1060 (1978).

44. 73 T.C. 5 (1979).

45. *Id.* at 11-12.

laneous Revenue Act of 1980.⁴⁶ The specific purpose of this Section is to expand the "aggregation web" of Sections 414(b) and (c), and reverse the results of the *Kiddie* and *Garland* decisions.⁴⁷ Section 414(m) introduces the "affiliated service group" ("ASG") as the solution to the *Kiddie-Garland* abuses. In an ASG, corporations and partnerships are aggregated based upon common or interlocking ownership and similarity of services rendered.⁴⁸ A law or medical partnership with one or more professional corporate partners, such as the structure in *Garland*, would result in the partnership and corporations being aggregated as one affiliated service group.⁴⁹ The impact of this classification is that all employees of the members of an affiliated service group are considered to be employed by one employer for the purposes of satisfying the antidiscrimination rules. Section 414(m) does not prevent the professional's use of a *Kiddie-Garland* type partnership of professional corporations; rather, it merely requires that retirement benefits comparable to those provided to the professionals in the group be provided to all eligible employees. The Service has provided detailed guidelines for determining comparability of benefits of this situation.⁵⁰

46. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 94 Stat. 3521 (1980).

47. See Maldonado, *Comparability of Contributions or Benefits Under Different Plans*, 55 J. TAX'N. 364 (1981).

48. The definition of an Affiliated Service Group ("ASG") includes a service organization and any other organization if a significant portion of the business of the other organizations is to perform services for the service organization in the same field and 10% or more of the other organizations is owned by officers, highly compensated employees or owners of the service organization.

The Internal Revenue Service presented the following example of an ASG consisting of corporations A, B and C and partnership P. The result of this classification is that all employees of A, B, and C and P are considered as employed by a single employer for purposes of the qualified plan antidiscrimination rules of I.R.C. Section 410(b).

"P, a law partnership consists of corporate partners A, B, C and 10 individual partners. Each of the partners owns less than 10% of the partnership. The partnership employs as common law employees some lawyers, paralegals, and clerical employees. The partnership has a qualified plan, Plan P, covering some but not all of the common law employees. Corporations A and B each have only one employee, the sole shareholder. Corporation A maintains a retirement plan, Plan A. Corporation B maintains no plan. Corporation C employs the sole shareholder, a lawyer employee, and three clerical employees. Corporation C maintains a retirement plan, Plan C, for all its employees. Corporations A, B, and C regularly perform services for P. No individual is a participant in more than one plan and none of the statutory exclusions of Section 410(b) applies." Rev. Rul. 81-105, 1981-12 I.R.B. 27; See also, Gehring, *Rev. Rul. 81-105 and the Use of Professional Service Corporation Partnerships After the Enactment of Code Sec. 414(m)*, 59 TAXES 371 (1981).

49. Rev. Rul. 81-202, 1981-2 C.B. 93.

50. *Id.*

The Impact of TEFRA

The scenario does not end with Section 414(m), however, as the recently enacted TEFRA provisions sound the death knell for new professional corporations by removing the economic incentives previously present in this type of planning. The major effect of TEFRA in this area is to create parity between corporate retirement plans and Keogh plans, thus removing the major economic incentive for incorporating.⁵¹

For years beginning after 1983, TEFRA eliminates almost all distinctions between corporate qualified deferred compensation plans and plans of self-employed individuals (Keogh Plans).⁵²

Under prior law, corporate retirement plans were particularly attractive to highly compensated individuals because of the significant amount of "shelterable" compensation. Maximum annual contributions to a profit-sharing or other defined contribution plans were the lesser of twenty-five percent of compensation or \$45,475.⁵³ Contributions to Keogh Plans, on the other hand, were limited to \$15,000 per year.⁵⁴ TEFRA equalizes these plans by limiting both corporate defined contribution plans and Keogh Plans to a maximum contribution of \$30,000 per year.⁵⁵ In addition, while a corporate defined benefit plan could fund for a maximum annual pension of \$136,425, TEFRA limits this amount to \$90,000 per year.⁵⁶ Although these limits on corporate plan contributions and benefits will impact only very highly compensated employees, other changes in corporate plan structure will make them less attractive to everyone.

Prior to the passage of TEFRA, defined benefit plans could increase today's contribution by setting the retirement age at 55. The earlier the date of retirement, the larger the contributions presently required to meet annual benefit amounts for years between retirement age and actuarially-determined date of death.⁵⁷ TEFRA changes this manipulation of benefits by retirement date by requiring that the amount of contributions for plans beginning before age 62 be reduced

51. *Employee Benefit Provisions of Tax Equity and Fiscal Responsibility Act*, Special Supplement, BNA Daily Tax Reports (Oct. 2, 1982).

52. TEFRA §§ 237-239, amending I.R.C. §§ 401, 404, 1379, 4972.

53. I.R.C. § 415(c).

54. I.R.C. § 404(e).

55. TEFRA § 235, amending I.R.C. § 415(c)(1) and TEFRA § 238, amending I.R.C. § 404(e).

56. TEFRA § 235, amending I.R.C. § 415(b)(1).

57. Assuming a male age 35 in a defined benefit plan set to produce a \$90,000 per year retirement benefit, the contributions required for various normal retirement dates are the following:

actuarially to the equivalent of the contributions for benefits beginning at age 62.⁵⁸

The Act also adds provisions defining and regulating a so-called "Top Heavy Plan."⁵⁹ Generally, a Top Heavy Plan is one in which 60 percent of the account balances (for a defined contribution plan) are held for the benefit of the key owners or officers of the organization.⁶⁰ The majority of professional and one-man corporation retirement plans will most likely be considered "Top Heavy" under TEFRA.⁶¹ A plan classified as Top Heavy must provide a faster vesting schedule⁶² than non-Top Heavy Plans and most accrue or contribute certain minimum non-integrated amounts for the non-key employees.⁶³

Besides the opportunity of sheltering large amounts of compensation as contributions, corporate plans were also attractive because participants could borrow from them.⁶⁴ TEFRA specifically limits this borrowing option by providing that all loans from qualified retirement plans above a specified amount will be treated as taxable gain to the

<u>Normal Retirement Age</u>	<u>Annual Contribution</u>
65	\$15,001
62	\$19,846
55	\$32,242

If the male is age 45 when he enters the same plan, then the comparable numbers are:

<u>Normal Retirement Age</u>	<u>Annual Contribution</u>
65	\$30,734
62	\$42,567
55	\$83,539

These computations are based upon a 5.5% earnings assumption and are for Straight Line annuity—1951 Group Annuity (Projection C to 55) post retirement interest 3.5%. [Computations supplied by Liden, Cogan & Assoc., Canoga Park, California].

58. TEFRA § 235(e), amending I.R.C. § 415(b)(2).

59. I.R.C. § 416, as added by TEFRA § 240.

60. I.R.C. § 416(i).

61. This stems from the planning for most professional type corporations, in which one of the primary goals is to allocate, within permissible limits, the bulk of the retirement contributions to the key owners or officers.

62. I.R.C. Code Section 411(a) provides the minimum vesting alternatives for a non-Top Heavy plan of: (1) full vesting within ten years ("cliff vesting"); (2) five to fifteen year vesting ("graded vesting"); or (3) generally when years of service plus age equal forty-five, the participant must be at least fifty percent vested ("Rule of 45"). If, however, the plan is Top Heavy, then it must use either of the following faster vesting schedules: (1) three year full vesting; or (2) two to six year graded vesting (I.R.C. § 416(b)).

63. For a defined benefit plan, generally this minimum is the accrual of a benefit equal to two percent of the employee's average compensation multiplied by the employee's years of service, with a twenty percent maximum. For a defined contribution plan, generally the non-integrated minimum contribution is three percent of the employee's compensation. I.R.C. §§ 416(c)(1), (2).

64. I.R.C. § 4975(d).

participant in the year of the loan.⁶⁵ The Act does, however, allow participants to borrow up to one-half of their vested benefits or \$50,000, whichever number is lower. These limitations apply to the total of all loans which the participant has outstanding in his or her retirement plans. Any loans which are taken from the plans must be repayable within five years of the loan and, in fact, be repaid within this time. There is a waiver of this five year repayment requirement if the loan is used to acquire, construct, reconstruct or substantially rehabilitate the participant's principal residence or the principal residence of a member of the participant's family. These rules were effective August 13, 1982. TEFRA does not change the prohibition of loans from Keogh plans.⁶⁶

TEFRA also has a devastating impact on individuals who formed their own corporations and sold their services to their employer-corporation or partnership. While this type of planning was initially approved by the Tax Court in *Keller v. Commissioner*,⁶⁷ the IRS fought back accordingly with the addition of new Section 269A to the Internal Revenue Code.⁶⁸ In *Keller*, one doctor in a partnership of physicians substituted his newly-formed professional corporation for himself as partner in the partnership. He was therefore an employee of Keller, Inc., which became the partner in the partnership. He received his salary from the corporation, which also provided the benefits of corporate retirement plans. The IRS attacked Dr. Keller's arrangement under the allocation of income doctrine.⁶⁹ This doctrine allows the Commissioner to allocate income among related taxpayers (here, the corporation and its employee) to prevent the evasion of taxes or to clearly reflect the income of each taxpayer's business activities. The Tax Court held that this doctrine applies to the one-man professional service corporation, but does not authorize allocation which would disregard the existence of the corporation. Thus, because Dr. Keller had followed corporate formalities, was conducting a business, and had satisfied the

65. *Supra* note 9.

66. I.R.C. §§ 4975(d), 401(c)(3).

67. 77 T.C. 1014 (1981).

68. TEFRA § 250, adding I.R.C. § 269A.

69. "ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or business, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." I.R.C. § 482.

arms-length test with regard to employment by the corporation, there would be no allocation of income under Section 482.

This victory was short-lived however. Section 269A of TEFRA was specifically aimed at *Keller*-type situations and will no doubt affect incorporated professionals, business consultants, technical specialists, sports stars and TV personalities. The very broad language of this section defines a "personal service corporation," and is aimed at anyone who performs substantially all services for one partnership or corporation. In such cases the IRS may choose to ignore the corporate form for tax purposes, thus subjecting the owner-employee to individual tax liability. The Section was intended to reach situations "where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available."⁷⁰ It was not aimed at smaller incorporated firms or incorporated sole practitioners performing services for a wide range of clientele. The focus of Section 269A is on the "personal service corporation" ("PSC") which is a corporation that primarily renders personal services which are substan-

70. Referring to the provisions of I.R.C. § 269A, the following was issued by the House Ways and Means Committee:

"The conferees intend that the provisions overturn the results reached in cases like *Keller v. Commissioner*, 77 T.C. 1014 (1981), where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available." CHH, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 at 311 (1982).

"SEC. 269A. PERSONAL SERVICE CORPORATIONS FORMED OR AVOIDED OF TO AVOID OR EVADE INCOME TAX.

"(a) GENERAL RULE.—if—

(1) substantially all of the services of a personal service corporation are performed for (or on behalf of) 1 other corporation, partnership, or other entity, and

(2) the principal purpose of forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available, then the Secretary may allocate all income, deductions, credits, exclusions, and other allowance between such personal service corporation and its employee-owners, if such allocation is necessary to prevent avoidance or evasion of Federal income tax or clearly to reflect the income of the personal service corporation or any of its employee-owners.

"(b) DEFINITIONS.—For purposes of this section—

(1) PERSONAL SERVICE CORPORATION.—The term 'personal service corporation' means a corporation, the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners.

(2) EMPLOYEE-OWNER.—The term 'employee-owner' means any employee who owns, on any day during the taxable year, more than 10 percent of the outstanding stock of the personal service corporation. For purposes of the preceding sentence, section 318 shall apply, except that '5 percent' shall be substituted for '50 percent' in Section 318(a)(2)(C).

(3) RELATED PERSONS.—All related persons (within the meaning of Section 103(b)(6)(c)) shall be treated as one entity."

tially performed by its owner-employees.⁷¹ Owner-employee is defined as any employee who owns more than ten percent of the outstanding stock on any one day during the corporation's fiscal year.⁷² The reallocation of income or deductions concept of Section 269A is only activated if the PSC renders substantially all of its services to one other corporation, partnership or other entity.⁷³ Section 269A would therefore apply to the incorporated doctor or lawyer, whose corporation is a partner in the practice partnership, as in *Kiddie*⁷⁴ and *Garland*.⁷⁵ It would also cover the incorporated athlete under contract to one club or the incorporated director or actor under contract to one studio. Any professional or similar type corporation which provided services to multiple clients would not, however, fall under the cloud of Section 269A.

Section 269A takes effect for taxable years beginning after December 31, 1982, but the Keogh Plan parity provisions of TEFRA are not effective until 1984. These staggered effective dates create uncertainty regarding a PSC's retirement plan status during 1983. Section 269A is directed at "securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available (outside the corporate form)."⁷⁶ As discussed, prior to TEFRA the primary purpose in professional corporation type planning was the utilization of corporate retirement plans, or, in other words, securing the benefit of the deductions which would not be available to the owner-employee outside the corporate form. This advantage of the corporate form will cease in 1984 when the Keogh parity provisions become effective; however, this advantage will still be available during 1983. The availability of this corporate form advantage prior to the effective date of TEFRA's Keogh parity provisions is what creates the uncertainty regarding 1983. This uncertainty seems, however, to have been eliminated by Senate Finance Committee Chairman Robert Dole, who stated:

I want to make it clear that under the conference agreement [TEFRA] a personal service corporation will not be considered to be formed or availed of for the purpose of evading or avoiding federal income tax solely because, for 1983, the

71. I.R.C. § 269A(b)(1).

72. I.R.C. § 269A(b)(2).

73. I.R.C. § 269A(a)(1).

74. *Supra* note 39.

75. *Id.*

76. I.R.C. § 269A(a)(2).

qualified plan rules will permit higher contributions and other advantages for corporate employees in applying Section 269A. Thus, the Secretary of the Treasury will not take a corporation's retirement plan into account.⁷⁷

Senator Dole's intent and interpretation on this point has been confirmed by a senior official of the Department of the Treasury.⁷⁸ Thus, for purposes of Section 269A, the tax benefits that would be available only in corporate form (and therefore at risk) do not include retirement plans, but would include any of the following used by a PSC: medical expense reimbursement plans;⁷⁹ group term life insurance;⁸⁰ deferral of taxable gain through a staggered corporate fiscal year; and accumulation of taxable income at lower corporate rates.⁸¹

With Section 269A creating a risk in using these secondary benefits in a PSC, and TEFRA bringing parity to corporate and non-corporate retirement plans, the economic incentives for most PSCs has been eliminated.

PSCs do, however, still serve a useful purpose in certain limited situations. A law firm or medical group with a significant age spread among its partners will, for example, still benefit from this planning. The benefit is derived from the different characteristics of defined benefit plans versus defined contribution plans, the two major types of corporate retirement plans available.⁸² By using a *Kiddle-Garland* type partnership of professional corporations, each partner could form his or her own corporation and substitute the corporation in his or her place as the partner in the partnership. Of course, a comparable retire-

77. 97 Cong. Rec. S-10903 (1982).

78. See, *Wall St. J.*, Oct. 20, 1982 at 1 (Tax Report).

79. Corporations may adopt these plans to cover employees for medical expenses incurred by them and their dependents. I.R.C. § 162(a) makes corporate contributions to these plans deductible by the corporation and under I.R.C. § 106 they are not taxable to the employee.

80. I.R.C. § 79; see also, Lewis, *Group Term Life Insurance—Section 79—TEFRA Changes*, COMPENSATION PLAN J. 3 (January 1983).

81. For example, a married individual filing a joint return with \$50,000 in taxable income owes \$14,778 in Federal income tax and is in the 49% tax bracket. A corporation with the same taxable income, however, owes only \$8,750 in income tax and is in the 30% bracket (I.R.C. §§ 1(a), 11).

82. Defined benefit plans are funded based upon a pre-determined goal (e.g. 50% of compensation as a pension). The older an individual entering this type of plan, the greater the contribution required because there are fewer years until retirement. Defined contribution plans (e.g. profit-sharing plans) are based on the total of each year's contribution plus earnings and operate without a fix pre-determined retirement goal. Younger individuals therefore tend to prefer defined contribution plans, while older individuals tend to favor defined benefit plans.

ment plan would also have to be adopted to cover the employees of the partnership.⁸³ This type of planning offers the benefits of allowing each partner to tailor a retirement package that best fits his or her age, tax planning, and retirement goals. Furthermore, each partner would have total control of the plan assets, and complete portability of benefits should he or she leave the group. In many situations, the advantages of this type of planning should outweigh the cost of creating the structure, or the risks upon fringe benefits caused by the PSC classification.

Professional corporation type planning has had a relatively short, but colorful history to date. TEFRA has not, however, rendered this planning extinct. Professional and similar type corporations which do not fit within the PSC classification are unaffected by Section 269A. Much of the economic incentive behind the choice of this form has been removed by the TEFRA concept of corporate retirement plan - Keogh parity; however, the other benefits available only in the corporate form⁸⁴ will, in many cases, still justify its use. Furthermore, even a PSC may serve a useful purpose in the limited settings which were noted. Although TEFRA does have a substantial impact upon professional and similar type corporations, it did not write the final chapter for this planning.

Authors' Note

Immediately prior to publication, the Department of the Treasury issued proposed regulations under Section 269A of the Code. The proposed regulations confirm the authors' interpretation of the Section 269A impact upon qualified retirement plans (*supra* p. 214). The proposed regulations also create a safe harbor from Section 269A if the tax avoidance involved is minimal. Prop. Treas. Reg. 1.269A-1, 48 Fed. Reg. 13438 (3/31/83).

83. This is required because of I.R.C. § 414(m) which was added to the Code to eliminate the discrimination problem in *Kiddie-Garland* type situations, *supra* pp. 109-111.

84. *Supra* notes 79-81.