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Attorney's Federal Income Taxes

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ATTORNEYS' FEDERAL INCOME TAXES

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I. GENERAL MATTERS

A. FORM OF ORGANIZATION—PROFESSIONAL ASSOCIATIONS

1. *Purpose of Professional Association Act.* Enactment of the Pennsylvania Professional Association Act[1] now enables two or more lawyers[2] who

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The subjects considered in this article are discussed only to the extent of aspects peculiar to attorneys' tax liability. No attempt is made to give general coverage to these subjects.

1. Pa. Laws 1961, act 416. Under the act an association which will render a particular kind of professional service may be formed by associates who are all qualified to render that professional service. Pa. Laws 1961, act 416, §§ 3, 4. The articles of association, containing the name of the association, its principal office address, the names and addresses of the associates, and a general purpose clause, must be filed with the local prothonotary. Pa. Laws 1961, act 416, § 5. The associates, according to proportionate ownership interests, Pa. laws 1961, act 416, § 16, elect a board of governors, which may consist of one or more persons who need not be associates, to manage the association's affairs. The board has the power to hire employees, who may be associates, Pa. Laws 1961, act 416, § 8, establish their salaries, Pa. Laws 1961, act 416, § 9, and determine what portion of the net earnings shall be distributed to the associates (in proportion to their ownership interests), Pa. Laws 1961, act 416, § 10. The associates are liable jointly, or jointly and severally, for the liabilities of the association. Pa. Laws 1961, act 416, § 17. Any associate no longer legally qualified to render the professional services which are the purpose of the association must be expelled. Pa. Laws 1961, act 416, § 18. Each associate or his estate and each expelled associate may transfer his interest to anyone qualified to render the professional services involved, subject to any restrictions imposed in the by-laws, Pa. Laws 1961, act 416, §§ 12, 18, and pursuant to agreement the association may redeem the interests of associates, expelled associates or their estates, Pa. Laws 1961, act 416, § 13. The association may be dissolved by a majority vote (or any larger vote required by the by-laws) of associates voting in accordance with their ownership interests. Pa. Laws 1961, act 416, § 19.

2. The choice between individual and group practice of law is based primarily upon considerations other than federal income taxes.

would heretofore have practiced as a firm to choose between a partnership and a professional association.[3] The Professional Association Act was drafted to permit those persons whose profession forbids their practicing through a corporation to form an organization which is a "corporation" for all purposes of the Internal Revenue Code of 1954.[4] The Treasury Regulations[5] specify the characteristics an organization must have in order to be an "association," which is taxed as a corporation. If a professional association qualifies as an association, and the associates[6] conform to the apparent requirement[7] in Pennsylvania that they become employees of the association, then they will also be treated for federal tax purposes as employees of the association.[8] This has several tax advantages.

2. *Tax Advantages of a Professional Association.* The major tax advantage for a professional association taxable as a corporation is probably that an associate-employee may be one of the beneficiaries of pension, profit-sharing,[9] stock bonus, and annuity plans, which, if they are non-discriminatory and otherwise qualified under Section 401 of the Internal Revenue Code of 1954, provide substantial tax benefits over investment programs that are not so qualified.[10] Other advantages relate to group life insurance cover-

3. Subject to any restrictions on lawyers imposed by professional ethics. *Cf.* Professional Association Act, Pa. Laws 1961, act 416, § 4. The Committee on Professional Ethics of the American Bar Association expects to render an opinion prior to 1962 as to the propriety of law firms practicing as entities, such as the professional association, that are taxable as corporations. 6 AM. B. NEWS, Oct. 15, 1961, p. 2. See notes 40, 52 and 65 *infra.*

4. "The term 'corporation' includes associations, joint stock companies, and insurance companies." INT. REV. CODE of 1954, § 7701(a)(3).

5. Treas. Reg. § 301.7701-2 (1960).

6. Owners of the proprietary interests in the association. Professional Association Act, Pa. Laws 1961, act 416, § 2(1).

7. See OP. ATT'Y GEN. No. 243, Sept. 27, 1961, n.12, and last sentence.

8. See Rev. Proc. 61-11, 1961 INT. REV. BULL. No. 18, at 53. For federal tax purposes no one can be an employee of a partnership of which he is a partner. *Id.* at 54.

9. Query whether professional ethics will prohibit the use of a profit-sharing plan where lay employees are covered, on the ground that this would constitute the sharing of professional fees with a layman in violation of Canon 34 of the Canons of Professional Ethics. *Report of the Special Committee to Cooperate With ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations,* A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 53. *Cf.* DRINKER, LEGAL ETHICS 185 (1953).

10. In general, the amounts contributed under a qualified plan are, subject to limitations as to amount, deductible in determining the taxable income of the employer. INT. REV. CODE of 1954, § 404. The employees covered by the plan do not include any of the amounts contributed in their gross income for that year, Treas. Reg. § 1.402(a)-1(a)(1)(i) (1956), except for the amounts allocable to life insurance protection, Treas. Reg. § 1.402(a)-1(a)(3) (1956), as amended, T.D. 6497, 1960-2 CUM. BULL. 19.

Any earnings of a qualified trust are exempt from federal income tax, INT. REV. CODE of 1954, § 501(a).

Upon termination of employment or death, if the employee or his estate or beneficiary receives in one taxable year all of the benefits to which he is entitled under the plan, then the entire amount is taxed at capital gains rates, INT. REV. CODE of 1954,

age,[11] medical, surgical, hospitalization and dismemberment insurance,[12] and health and accident plans.[13]

There is another tax reduction advantage,[14] independent of employee benefit plans, which results from the creation of a new taxpaying entity. The association taxed as a corporation is subject to federal tax at 30 percent of income up to 25,000 dollars,[15] and Pennsylvania corporate net income tax[16] of 6 percent.[17] If a group of lawyers were practicing in partnership, the partners would pay federal income taxes at individual tax rates on the

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§ 402(a)(2), except that the proceeds of life insurance protection, Treas. Reg. § 1.402(a)-1(a)(4)(i)(b) (1956), and in some cases the first $5,000 of death benefits, Treas. Reg. § 1.402(a)-1(a)(4)(i)(c) (1956), are receivable free of income tax. If received under any other circumstances, all amounts paid to the employee are taxed at ordinary income rates under INT. REV. CODE of 1954, § 72, relating to annuities, except that § 72(e)(3) is not applicable. INT. REV. CODE of 1954, § 402(a)(1). If an employee dies before retirement, then any death benefits, other than those constituting life insurance proceeds or payable to his estate, are free from the federal estate tax, INT. REV. CODE of 1954, § 2039(c), Treas. Reg. § 20.2039-1(d) (1958). For requirements for exemption from Pennsylvania inheritance and estate taxes, see Inheritance and Estate Tax Act of 1961, § 316, Pa. Laws 1961, act 207, § 316.

Therefore, under a qualified plan, the funds are accumulated and invested almost entirely free from income taxes until benefits are distributed to the employee. In addition, distribution to the beneficiary ordinarily results in taxation at lower income tax rates than he was paying while he was employed, because of the graduated income tax rates, his probably reduced earnings after retirement, and the retirement income credit, INT. REV. CODE of 1954, § 37, or the maximum 25% tax on long-term capital gains, INT. REV. CODE of 1954, § 1201(b).

11. If the association pays the cost of group term life insurance coverage for employees, then, whether or not they are also associates, the amounts paid will be deductible in determining the association's taxable income, Adolph G. Rosengarten, 12 P-H Tax Ct. Mem. 297 (1943), but will not be includible in the gross income of the employees, Treas. Reg. § 1.61-2(d)(2) (1956).

12. If an employer pays the cost of medical, surgical, or hospitalization insurance, or insurance against dismemberment, then the employer may deduct these costs in determining its taxable income, Treas. Reg. § 1.162-10(a) (1958), and the employee excludes these contributions from his gross income, INT. REV. CODE of 1954, § 106. The employee may also exclude from his gross income amounts collected under such insurance policies on account of dismemberment or as reimbursement for medical care expenses for himself, his spouse, and his dependents, except to the extent that these medical expenses were deducted in prior years. INT. REV. CODE of 1954, § 105(b) and (c).

13. If an employer continues the salary of an employee while he is absent from work on account of personal injuries or sickness, then the employer may deduct the entire amount paid, Treas. Reg. § 1.162-10(a) (1958), but the employee may exclude the amount paid up to a weekly rate of $100 (except for the first seven calendar days of absence in the case of an employee absent on account of sickness and not hospitalized for at least one day during those seven days), INT. REV. CODE of 1954, § 105(d). If the employer provides these benefits by paying for an insurance policy, then he may deduct the cost of the premiums, Treas. Reg. § 1.162-10(a) (1958), but the employee excludes the amount of these premiums from his gross income, INT. REV. CODE of 1954, § 106.

14. Not available if election is made under Sub-chapter S, see Part I A5, p. 83 *infra*.

15. INT. REV. CODE of 1954, § 11.

16. See notes 72 and 73 *infra* and accompanying text.

17. Corporate Net Income Tax Act § 3, PA. STAT. ANN. tit. 72, § 3420c (Supp. 1960).

entire taxable income of the partnership.[18] If any partner's individual federal tax bracket was over 36 percent,[19] and it was desirable to distribute less than all of the net earnings,[20] then their taxes might be lower if they practiced in a professional association and set their salaries as employees at a level which would keep the association's corporate taxes at 36 percent and their individual taxes at no more than 36 percent. Each associate could realize his share of the accumulated profits at capital gains rates by selling his interest, or his estate could realize his share without further income tax by selling it promptly after his death.[21]

3. *The Treasury Regulations and the Professional Association.* The professional association is intended to qualify as an association taxable as a corporation under the Treasury Regulations.[22] At this writing, there has been no ruling[23] by the Internal Revenue Service with respect to any organization formed under the Pennsylvania Professional Association Act

18. INT. REV. CODE of 1954, § 701.

19. This rate is reached at $20,000 of taxable income by a lawyer filing a joint return, at $14,000 of taxable income by an attorney filing as head of a household, and at $10,000 of taxable income by all others. INT. REV. CODE of 1954, §§ 1, 2.

20. As might be the case if the partners were making payments on a mortgage or otherwise buying capital assets.

21. When its basis will be equal to its fair market value, INT. REV. CODE of 1954, § 1014, so that there would be no gain, INT. REV. CODE of 1954, § 1001.

22. Treas. Reg. § 301.7701-2 (1960). If a group of attorneys fails in its attempt to be taxed as a corporation, it would ordinarily be taxed as a partnership, which ordinarily would impose only those tax liabilities that would have existed had they formed an ordinary partnership, except for any Pennsylvania taxes. See text accompanying notes 72 and 73 *infra*.

23. Rev. Proc. 61-11, *supra* note 8, establishes the procedure for obtaining a determination from the District Director as to the related issues of the status of an association and the existence of an employer-employee relationship between it and its owners. This procedure is applicable only where these issues arise in connection with a request for a determination that an employee plan qualifies under INT. REV. CODE of 1954, § 401, and results in a preliminary determination with respect to these issues. In making his request for a determination as to the employee plan, the employer must submit a brief with respect to the association's status and its relationship with the alleged employees, together with copies of all relevant documents and a statement of all pertinent facts. The employer should then ask for an oral discussion of these issues in the National Office of the Internal Revenue Service. If the District Director's opinion is that the employer is an association taxable as a corporation and that the requisite employer-employee relationship exists, or if he wishes the views of the National Office of the Internal Revenue Service, he will refer the case to the National Office together with his findings and recommendations. The National Office will determine the status of the organization and the alleged employees. If the District Director determines that the organization is not an association taxable as a corporation, or that its associates are not employees, it will so advise the organization. There is no appeal from an unfavorable determination by the District Director or the National Office. Treas. Reg. § 601.201, 26 C.F.R. § 601.201 (1961).

Suit for declaratory judgement in the U.S. District Courts is not available, 28 U.S.C. § 2201 (1959), Noland v. Westover, 172 F.2d 614 (9th Cir. 1949), whether the determination is unfavorable or the procedure established by Rev. Proc. 61-11, note 8 *supra*, is inapplicable, as it would be if no employee plan was proposed. The taxpayers would have to take their chances on the ordinary audit and appeal procedures that follow the filing of a return.

or comparable laws. The Regulations[24] indicate that, in order to qualify, an organization must first have "associates"[25] and the purpose of conducting a business for profit.[26] Additionally, the organization must have more corporate characteristics than noncorporate characteristics.[27] The following are corporate characteristics:[28] (1) Continuity of life—the attribute of an organization's continuing without alteration of identity regardless of the death, withdrawal, insanity, or other disability of any of its associates.[29] (2) Centralization of management—the attribute whereby any person or group which does not include all of the associates has the exclusive power to make independent business decisions not requiring ratification by the associates.[30] (3) Limited liability—the attribute whereby the associates are not personally liable for the debts of the association.[31] (4) Free transferability of interests—the attribute whereby each member, without the consent of other members, has the power to confer upon one who is not a member all of the attributes of his interest in the organization;[32] but if each member has this power only after offering his interest to the other members at fair market value, then there is a modified form of free transferability of interest, with somewhat less significance.[33] Furthermore, there may be other characteristics which in a particular case may determine whether or not the organization has more corporate characteristics than noncorporate characteristics.[34]

Of the four corporate characteristics listed, the professional association

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

25. By using the plural, the Regulations indicate that a professional association formed with but a single associate would not qualify, although § 3 of the Professional Association Act permits a single associate to form a professional association. What would happen upon the death or withdrawal of one of two associates is not clear. Nor it is clear whether an association could qualify under the Regulations, for example, with one associate owning 99% of the association and one or more others owning the balance.

26. There appears to be no reason why an association of lawyers would not qualify in this respect.

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

28. And the absence of each is presumably a noncorporate characteristic.

29. Treas. Reg. § 301.7701-2(a)(1) and (b) (1960).

30. Treas. Reg. § 301.7701-2(a)(1) and (c) (1960).

31. Treas. Reg. § 301.7701-2(a)(1) and (d) (1960).

32. Treas. Reg. § 301.7701-2(a)(1) and (e) (1960).

33. Treas. Reg. § 301.7701-2(e)(2) (1960). The effect of this lesser significance is not indicated in the Regulations. See Treas. Reg. § 301.7701-2(g), Example (1), (5) and (6) (1960). Perhaps where additional characteristics are involved, see note 34 *infra*, the lesser significance of a modified form of free transferability will determine whether an organization qualifies.

34. Treas. Reg. § 301.7701-2(a)(1) (1960). Since the Regulations were drafted before the Treasury Department had any appreciable experience with the type of organizations they cover, the fact that no examples of these other characteristics are given should not be taken as an indication that they will not be significant in particular cases.

has continuity of life,[35] but it does not have limited liability.[36] Therefore, in order to have a majority of the corporate characteristics listed in the Regulations, the professional association must have centralization of management and at least some recognized form of free transferability of interests.

Centralization of management can be met by an association with two or more associates, at least in form, by having a board of governors which does not include all of the associates.[37] This would in form meet the requirements of the Regulations[38] since Section 6 of the Professional Association Act[39] provides that the board of governors elected by the associates shall manage all of the affairs of the association,[40] and the Act empowers the board to hire employees,[41] set their salaries[42] and determine what portion of the net earnings of the association is to be distributed among the associates in proportion to their ownership interests.[43] To permit a two-associate association to meet the requirement of centralization of management, the board of governors may consist of one person.[44] However, it may be that the Treasury Department will impose and try to enforce an additional requirement that managerial decisions be made without the prior acquiescence of those associates who are not on the board of governors.[45] No problem of qualification arises from the Pennsylvania rule[46] that at least a majority of the members of the board be attorneys who are members of the association,

35. "Neither death, bankruptcy, resignation, expulsion, insanity, retirement, nor transfer or redemption of the interest, of any associate, shall cause its dissolution." Professional Association Act, Pa. Laws 1961, act 416, § 14.

36. Professional Association Act, Pa. Laws 1961, act 416, § 17, which is comparable to Uniform Partnership Act §§ 13-15, PA. STAT. ANN. tit. 59, §§ 35-37 (1930).

37. Treas. Reg. § 301.7701-2(c) (1960), Professional Association Act, Pa. Laws 1961, act 416, § 6.

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

39. Pa. Laws 1961, act 416, § 6.

40. For an attorney to practice subject to the direction of a board of governors consisting entirely of attorney-associates would seem not to violate Canon 31 of the Canons of Professional Ethics, requiring an attorney to be free to choose his clients, or Canon 35, which forbids an attorney's services from being controlled by any lay agency intervening between him and the client, any more than these Canons are violated by the many attorneys now practicing as employees of law partnerships. Some acceptance of this position is indicated in *Report of the Special Committee to Cooperate With ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations*, A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 50-51. Query whether the same could be said of an association whose board includes a minority of non-attorneys, as may be suggested by OP. ATT'Y GEN. No. 243, Sept. 27, 1961.

41. Professional Association Act, Pa. Laws 1961, act 416, § 8.

42. Professional Association Act, Pa. Laws 1961, act 416, § 9.

43. Professional Association Act, Pa. Laws 1961, act 416, § 10.

44. Professional Association Act, Pa. Laws 1961, act 416, § 6.

45. This will be a difficult thing for the Internal Revenue Service to enforce, and the Service might in some manner impose on the association the burden of showing that this suggested requirement is met. If this requirement is imposed, it would prove most difficult for those associations made up of relatively few associates with approximately equal interests.

46. See OP. ATT'Y. GEN. No. 243, Sept. 27, 1961.

or from a possible requirement[47] that all members of the board be attorneys and associates.[48]

The requirement of free transferability of interests was intended by the draftsmen of the Professional Association Act to be met by Section 12 which reads:

> Transfer of Interests. Any association or the personal representative of his estate may transfer in whole or in part his interest in a professional association, provided, however, that the transferee shall be licensed or otherwise legally authorized to render the same kind of professional service which the professional association was organized to render. If any restrictions are imposed on the right to transfer, such restrictions shall be specifically set forth in the by-laws of the association and reference to the restriction shall be set forth either generally or specifically on any certificates which evidence ownership in the association.

Nothing in this section would prevent the association from meeting the requirement of free transferability of interests.[49] Nor would this attribute be lost by the requirement of Section 18 of the act that any associate no longer qualified to render professional services be expelled,[50] or by the authority granted to the association in Section 13 to redeem the interest of any associate or expelled associate or his estate, pursuant to prior agreement. However, in finding the professional association to have free transferability of interests, problems may be raised by the suggested requirement that all associates must be employees,[51] by professional ethics,[52] or by restrictions that may be im-

47. See note 40 *supra*.

48. Treas. Reg. § 1.7701-2(c)(2) (1960) (*semble*).

49. But see *Report of the Special Committee to Cooperate With ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations*, A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 52, which suggests that the restriction on transferability of interests to lawyers only may be one of the other characteristics referred to in Treas. Reg. § 301.7701-2(a)(1) (1960), which tends toward making the organization noncorporate.

50. However, this might be one of the "other" characteristics referred to in Treas. Reg. § 301.7701-2(a)(1) (1960), see note 34 *supra* which tends toward making the association non-corporate.

51. See note 7 *supra*. The problem is raised by the following argument: Since all associates must be employees, and power of employment is given to the board of governors (which must be primarily or wholly composed of associates and which is elected by all of them), the associates or some of them can effectively exercise a veto over the transferee of any interest by causing the board of governors to refuse to hire him; for practical purposes this amounts to the forbidden need for consent "of other members," Treas. Reg. § 301.7701-2(e)(1) (1960). See *Report of the Special Committee to Cooperate With ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations*, A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 53. One answer that has been suggested is to have the by-laws require the employment of each associate at reasonable compensation. (But such a provision may be ineffective in view of the statutory grant to the board of governors of power to hire employees. Professional Association Act, Pa. Laws 1961, act 416, § 8. Alternatively, it may be interpreted as unduly violating centralization of management, Treas. Reg.

posed by agreement.[53]

If a professional association is held not to be an association as defined in Treas. Reg. 301.7701-2 (1960), an attempt should be made to have it recognized as a joint-stock company taxable as a corporation.[54]

4. *Partnership Associations and Registered Partnerships.* Aside from the professional association, the partnership association[55] and the registered

§ 301.7701-2(c) (1960), by giving each associate the power to force any attorney on the association as an employee by transferring a part of his interest to him. And as a practical matter, lawyers may not want to take the chance of being compelled to find and use indirect methods to prevent an undesirable transferee from joining them in their practice.) A second suggested answer is that the board's power of employment must be exercised in a fiduciary capacity, *cf.* Business Corporation Law § 408, PA. STAT. ANN. tit. 15, § 2852-408 (1958), for the benefit of the common good of the association rather than for the individual benefit of the board members or of less than all of the associates. *Cf.* Higgins v. Chenango Pottery Co., 256 F.2d 504 (3d Cir. 1958); 13 AM. JUR. *Corporations* § 997 (1938); 9 P.L.E. *Corporations* § 202 (1958). In effect, the board members who are associates must act as if they were not associates. This being the case, it is not the members of the association who may refuse to hire a transferee and prevent him from lawfully exercising the attributes of an associate, but rather the board of governors. A third suggested answer is that the Regulations merely require each member to have the power to transfer to another all his ownership interests. Treas. Reg. § 301.7701-2(e)(1) (1960). It is arguable that the Attorney-General's Opinion does not prevent this, but merely forbids the association from actively practicing its profession so long as it has an associate intended not to be hired or an associate who has been such for an appreciable time and has not been hired. See OP. ATT'Y. GEN. No. 243, Sept. 27, 1961.

52. Canon 34 of the Canons of Professional Ethics provides, "No division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility." It has been suggested that this Canon might require "some provision for frequent and compulsory adjustment of stock ownership . . . to insure that distributions from year to year will be based on service or responsibility." *Report of the Special Committee to Cooperate with ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations*, A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 53. It is not indicated why this provision would be required for an association any more than for a partnership. It has likewise been suggested that if earnings are accumulated and are to be distributed when ownership interests are no longer appropriately related to the service and responsibility at the time the fees were earned, then Canon 34 requires either that there must be "rigid formulas to determine price so that the seller receives exactly his due for his past services and the buyer cannot benefit from past accumulation of fees," or that "maintenance of the proper relationships in the case of realizations by sale of the stock will be troublesome." *Id.* This problem would seem not to arise until and unless there is a sale of an interest at an improper amount.

53. To what extent will restrictions imposed by voluntary agreement among the associates, to which the association is not a party, be taken into account in determining whether the association has the attribute of free transferability of interest? Will it matter whether these agreements are entered into concurrently with the formation of the association or afterwards? To what extent will voluntary agreements between the association and the associates be taken into account? If on the basis of the agreements that are taken into account, an associate may not transfer his interest to anyone, unless the transferee is approved by one or more associates, then probably not even a modified form of transferability exists. Treas. Reg. § 301.7701-2(e) (1960); *Report of the Special Committee to Cooperate With ABA Committee on Professional Ethics Re Associations of Attorneys Taxable as Corporations*, A.B.A. SECTION OF TAXATION BULL. October 1961, at 41, 52.

54. INT. REV. CODE of 1954, § 7701(a)(3), quoted in note 4 *supra.*

55. PA. STAT. ANN. tit. 59, §§ 341-461 (1930 and Supp. 1960).

partnership[56] may be used in Pennsylvania to qualify as associations taxable as corporations under the Regulations.[57] They can have associates,[58] business purpose,[59] continuity of life,[60] centralization of management (except for a partnership association with only three members),[61] and limited liability,[62] and, if appropriate by-laws are adopted, they may have free transferability of interests.[63]

The Pennsylvania Attorney General has ruled[64] that upon meeting stated requirements physicians may practice in a partnership association as well as in a professional association. It would appear that this may also be true of attorneys.[65] However, there are inconveniences in the use of a partnership association[66] and a registered partnership[67] that are avoided in the professional association.

5. *Sub-Chapter S.* If a professional association meets the requirements of the Regulations,[68] and comes within the definition of a corporation in Section 7701 (a)(3), then it is a corporation[69] for the purpose of Subchapter S,[70] which authorizes a corporation and its shareholders to elect to have the income of the corporation taxed directly to the shareholders, much in the manner that the partners of a partnership are taxed. However, a professional association with more than ten associates would not be able to take advantage of this election.[71]

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56. PA. STAT. ANN. tit. 59, §§ 241-321 (1930).

57. Treas. Reg. § 301.7701-2 (1960).

58. PA. STAT. ANN. tit. 59, § 341 (1930) (partnership association, three or more persons); PA. STAT. ANN. tit. 59, § 241 (1930) (registered partnership, two or more persons).

59. *Ibid.*

60. See PA. STAT. ANN. tit. 59, § 421 (1930) (partnership association); PA. STAT. ANN. tit. 59, § 292 (1930).

61. PA. STAT. ANN. tit. 59, § 401 (1930) (partnership association, at least three managers); PA. STAT. ANN. tit. 59, § 263 (registered partnership).

62. PA. STAT. ANN. tit. 59, § 381 (1930) (partnership association); PA. STAT. ANN. tit. 59, § 261 (1930) (registered partnership).

63. See PA. STAT. ANN. tit. 59, § 383 (1930) (partnership association); PA. STAT. ANN. tit. 59, § 269 (1930) (registered partnership).

64. OP. ATT'Y GEN. No. 243, Sept. 27, 1961.

65. The Florida Supreme Court has ruled that attorneys may make use of the Professional Service Corporation Act, Fla. Laws 1961, ch. 61-64. In re The Florida Bar, 30 U.S.L. WEEK 2177 (Fla. Oct. 11, 1961).

66. The word "Limited" must be the last word of the partnership association's name, which must appear fully in a conspicuous place in the association's office and on its correspondence. PA. STAT. ANN. tit. 59, § 382 (1930). The signatures of at least two managers are needed to bind the association for any debt exceeding $500. PA. STAT. ANN. tit. 59, § 401 (1930).

67. A list of the partners must be posted in a public place in the partnership's office containing the capital subscribed and paid by each partner, and the words "Limited Liability" after the name of each partner. PA. STAT. ANN. tit. 59, § 265 (1930).

68. Treas. Reg. § 301.7701-2 (1960).

69. Treas. Reg. § 1.1371-1(b) (1959).

70. INT. REV. CODE of 1954, §§ 1371-1377.

71. INT. REV. CODE of 1954, § 1371(a)(1).

6. *Pennsylvania Taxes.* The professional association appears to be subject to the Pennsylvania capital stock and corporate net income taxes. The capital stock tax is imposed upon every corporation (other than certain non-profit corporations), "and every joint-stock association, limited partnership, and company whatsoever," organized or incorporated under any laws of Pennsylvania.[72] The corporate net income tax is imposed upon every corporation with capital stock, joint-stock association, or limited partnership, which does business in Pennsylvania, or has capital or property used in Pennsylvania or carries on activities in Pennsylvania.[73] The professional association would appear to be a joint-stock association for the purposes of these acts.[74] The professional association would appear not to be subject to any taxes imposed only on corporations, limited partnerships,[75] partnership associations, or registered partnerships, because these terms do not describe the professional association.

B. METHOD OF ACCOUNTING; RECORD-KEEPING; FRAUD AND NEGLIGENCE PENALTIES

Attorneys would ordinarily benefit from the use of the cash receipts and disbursements method of accounting,[76] since they ordinarily pay their expenses as they are incurred but receive payment of fees sometime after they have been earned.[77] An attorney who is also engaged in another trade or business may use a different method of accounting for his profession and for each trade or business.[78] However, a complete and separable set of books and records must be kept for each trade or business.[79]

Each attorney should keep such permanent books of account as are sufficient to establish the amount of gross income, deductions, credits, or other matters germane to his tax returns.[80] The forms and systems of accounting

72. PA. STAT. ANN. tit. 72, §§ 1871, 1901, 1902 (1949 and Supp. 1960).
73. PA. STAT. ANN. tit. 72, §§ 3420b, 3420c.
74. See the description of the attributes of a "joint-stock company" in Oliver's Estate, Appeal of Merchant's Fund Association, 136 Pa. 43 (1890).
75. The professional association is not "limited" and it is not a "partnership." "Limited partnership" in the taxing acts has been interpreted to refer to the partnership association, PA. STAT. ANN. tit. 59, §§ 341-461 (1930 and Supp. 1960), and the registered partnership, PA. STAT. ANN. tit. 59, §§ 241-321 (1930), but not to the entity authorized by the Uniform Limited Partnership Act, PA. STAT. ANN. tit. 59, §§ 171-228 (1930). Commonwealth v. Biddle & Henry, 2 D. & C. 705 (Pa. 1923), following OP. ATT'Y. GEN.—In re Taxation of Limited Partnerships, 5 Pa. Dist. 288 (1896), and OP. ATT'Y. GEN.—Limited Partnership Taxation, 28 County Ct. 582 (Pa. 1903).
76. Authorized by INT. REV. CODE of 1954, § 446(c)(1).
77. An attorney who ordinarily receives substantial portions of his income in the form of retainers before performing work would gain no advantage by using the accrual method of accounting, because such receipts would be taxable when received even under the accrual method. Rev. Rul. 60-85, 1960-1 CUM. BULL. 181.
78. INT. REV. CODE of 1954, § 446(d).
79. Treas. Reg. § 1.446-1(d)(2) (1957).
80. Treas. Reg. § 1.6001-1(a) (1959).

used should permit the Internal Revenue Service to determine what the tax liability is.[81]

Detailed records relating to travel, entertainment, education, promotional, and club expenses are necessary, and particularly records evidencing the business (as opposed to personal) nature of expenses of this type.[82] In a recent case,[83] the Tax Court wholly approved the disallowance by the Commissioner of Internal Revenue of what amounted to 82 percent of approximately 48,000 dollars claimed by an attorney as deductions (over a period of three years) for these categories of expenses, solely or primarily on the ground that the attorney had not shown them to be related to his profession.[84]

Conviction for criminal violation[85] of Federal income tax laws, the imposition of the penalty[86] for failure to file a return on time,[87] the fifty percent penalty for underpayment of tax due to fraud,[88] the five percent penalty for negligent underpayment of tax[89] and certain other civil penalties are dependent upon the presence of (1) an understatement of tax or other violation of the Code, and (2) a state of mind of the taxpayer which is characterized by words such as "willfully," "reasonable cause," "willful neglect," "fraud," "negligence," and "intentional disregard of rules and regulations." In applying the rules growing out of the interpretation of these words, a taxpayer seems sometimes to be held to a higher standard if he is an attorney.[90]

81. Treas. Reg. § 31.6001-1(a) (1959). The accounting methods should also be standard enough, and the entries detailed enough, that if the attorney becomes unavailable to explain them (because of death or otherwise), the rights of his estate and his former clients will be determinable.

82. Robert R. Williams, Jr., 24 P-H Tax Ct. Mem. 311 (1955) (compare the court's allowance of the part of the expenses on the Hopedale trip shown to be related to the taxpayer's profession with its disallowance of all expenses on the Miami trip).

83. Reginald G. Hearn, 36 T.C. No. 69, 1961 P-H Tax Ct. Rep. & Mem. Dec. ¶ 36.69 (1961).

84. "The expenses in question are of such nature as to afford considerable opportunity for abuse, and it is not too much to ask of a taxpayer seeking the benefit of such deductions that he offer not only reasonably satisfying proof that the expenses were in fact incurred but also that they bore a proximate relationship to the conduct of his business." *Id.* at —, 1961 P-H Tax Ct. Rep. & Mem. Dec. ¶ 36.69, at 488.

85. Int. Rev. Code of 1954, §§ 7201, 7203, 7206, 7207.

86. 5% per month of tax due, with a maximum of 25%. Int. Rev. Code of 1954, § 6651.

87. *Ibid.*

88. Int. Rev. Code of 1954, § 6653(b).

89. Int. Rev. Code of 1954, § 6653(a).

90. In Ripperger v. United States, 248 F.2d 944 (4th Cir. 1957), *cert. denied*, 355 U.S. 940 (1958), affirming conviction under § 7203 of the 1954 Code and the corresponding section of the 1939 Code for "willfully" failing to file a required return, the court said:

> He was a lawyer of 35 years of age who had been filing tax returns for others and *must have known* of the duty resting upon those with an income such as his to file tax returns. His explanation that he did not know that the law required the filing of the returns when he did not have the money to

II. SPECIFIC MATTERS

A. Income Items

1. *Compensation Includible in Gross Income.* Legal or other services performed gratuitously for another do not result in gross income to an attorney.[91] However, if an attorney renders services to one person and pursuant to a prior understanding such person pays an amount to some other person (such as a charity), the amount so paid constitutes income to the attorney performing the services.[92]

If an attorney receives payment for his services in some form other than money, then his gross income must include the fair market value of the property or services received.[93] For example, stock given by a corporation for legal services to be performed constitutes income to the attorney at the time he receives the stock.[94] Notes or other evidence of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of receipt.[95] If a note received as compensation is regarded as good for its face value at maturity but does not bear interest, the fair market value of the note is its fair discounted value computed at the prevailing interest rate.[96] As payments are received on such a note, the attorney must include in his income at the time of receipt that portion of the payment which represents the proportionate part of the discount originally taken on the entire note.[97]

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pay the tax *is so unreasonable* that the judge was thoroughly justified in not accepting it. *Id.* at 945. (Emphasis added.)

In George C. Johnson, 21 P-H Tax Ct. Mem. 23 (1952), appeal dismissed, August 13, 1953, the Tax Court imposed the 25% penalty for the failure to file a timely return not shown to be due to reasonable cause, imposed by the 1939 Code equivalent of § 6651(a) of the 1954 Code. In this case, an attorney had formed what he considered to be a tax-free educational or religious foundation, and one of the benefits of membership was the free preparation of tax returns by the attorney. Contributions to the foundation found to have been paid in order to have tax returns prepared were held to be income to the taxpayer under Treas. Reg. 111 § 29.22(a)-2. (See Treas. Reg. § 1.61-2(c) under the 1954 Code.) In justifying the penalty for negligence, the court said:

> Considering that petitioner was an attorney, who prepared tax returns for others, and who failed to file his own return, we can only say his failure to file was due to wilful neglect. George C. Johnson, *supra*, at 27.

But see Edward C. Koeneman, 27 P-H Tax Ct. Mem. 807 (1958), where the Tax Court said, in refusing to impose either a fraud or a negligent penalty:

> To sustain respondent [Commission of Internal Revenue] on the record made with respect to this issue, would require us to hold that the bare failure of an attorney possessing some knowledge of the requirements of Federal tax law to file returns, amounts to fraud with intent to evade tax on the part of such an attorney. This we are unwilling to do. Fraud implies bad faith, intentional wrong-doing, and a sinister motive. *Id.* at 810.

91. *Accord.* Treas. Reg. § 1.61-2(c) (1957).
92. *Accord.* Treas. Reg. § 1.61-2(c) (1957).
93. Treas. Reg. § 1.61-2(d)(1) (1957).
94. Allen v. Commissioner, 107 F.2d 151 (4th Cir. 1939).
95. Treas. Reg. § 1.61-2(d)(4) (1957).
96. *Ibid.*
97. *Ibid.*

A gift received by an attorney from a client unrelated to legal services is excluded from gross income.[98]

2. *Long-Term Employment.* In order to reduce the higher taxes that result from the "bunching" of income in one year, Section 1301 of the Internal Revenue Code of 1954 in effect permits an attorney to spread out over two or more taxable years compensation received on account of an "employment" covering thirty-six months or more, if at least eighty percent of the total compensation on account of such employment is received in one taxable year.

An "employment" means an arrangement for the performance of personal services to effect a particular result.[99] Fees received by an attorney from his client under a general retainer are not subject to Section 1301 even if the attorney spent more than thirty-six months on a single project, because the arrangement between the attorney and his client was for services generally and not for a particular result.[100] However, an attorney may be retained for a specific result whether or not he is also on general retainer for a client.[101] In determining whether "an employment" exists, it does not matter that there may be more than one client, so long as the arrangement is for a particular result.[102] The primary factor in determining whether "an employment" exists is what the particular profession or business would normally consider as a distinct project or result.[103]

Service as a trustee is an "employment."[104] An attorney who is both a fiduciary of and counsel for an estate treats his legal fees and commissions as receipts attributable to two separate employments.[105] In certain circumstances, an attorney who, as executor, performs special legal services may be able to treat these services as a separate employment.[106] In a recent suit in the District Court for refund of income taxes erroneously paid, a jury determined[107] that an attorney had had separate employments where he had represented a single client in connection with income taxes for separate taxable years, even though the issue was the same in each taxable year.

98. Dupuy G. Warrick, 44 B.T.A. 1058 (1941).
99. INT. REV. CODE of 1954, § 1301(b).
100. Treas. Reg. § 1.1301-2(b)(2), Example (1) (1958).
101. Treas. Reg. § 1.1301-2(b)(2), Example (2) (1958); Estate of Marion B. Pierce, 24 T.C. 95 (1955).
102. Treas. Reg. § 1.1301-2(b)(1)(i) (1958). For example, an attorney might be retained by several independent clients to have a statute or administrative rule declared invalid.
103. Treas. Reg. § 1.1301-2(b)(1)(ii) (1958). Estate of Marion B. Pierce, *supra* note 101.
104. Rev. Rul. 57-436, 1957-2 CUM. BULL. 588.
105. Leon R. Jillson, 22 T.C. 1101 (1954), *acq. on this issue*, 1955-1 CUM. BULL. 5.
106. Chase v. Commissioner, 245 F.2d 288 (9th Cir. 1957), *reversing* 25 T.C. 398 (1955). *Contra*, Rosalyne A. Lesser, 17 T.C. 1479 (1952).
107. McDonnald v. United States, 7 Am. Fed. Tax R.2d 692 (D. Tex. 1961).

In determining whether or not an employment covers a period of thirty-six months, there is included the time spent by the attorney in unsuccessful attempts to effect the desired result.[108] Whether time spent in conference and study is to be included depends upon the facts of the particular case.[109]

In determining whether at least 80 percent of the compensation for the employment is received in a single taxable year, reimbursement for expenses advanced are disregarded.[110] The requirement is not met if the amounts constituting 80 percent are received in two different taxable years,[111] as for example, in the case of a calendar year taxpayer receiving one-half of his fee at the end of December 1961 and the other half of his fee at the beginning of January 1962.

If an attorney is engaged in an "employment" which covers a period of thirty-six months or more, and in a single taxable year the attorney receives at least 80 percent of the total compensation for that employment, then the tax paid by the attorney on the amounts received in that taxable year for the employment may be no greater than the taxes that would have been payable if each amount received during that taxable year had instead been received ratably between the time the employment began and the date of receipt.[112] The compensation can be received at any time during the employment, but obviously Section 1301 is of no value if 80 percent of the compensation is received in the year in which the employment begins.

The method of computing the limitation on tax is described in the Regulations.[113] In general, there must first be computed the total tax that would be payable for the year without regard to Section 1301.[114] This will be the tax for the year unless the alternative method results in less tax.[115] Under the alternate method, the tax for the year is computed excluding from income the entire amount received on account of the long-term employment.[116] Then, each payment received on account of the employment during the taxable year must be allocated on a monthly basis between the time the employment began and the time of that payment.[117] There must then be calculated the increases in tax that would have occurred in prior years and in the current year if the amounts had actually been received as allocated.[118]

108. Treas. Reg. § 1.1301-2(b)(1)(iv) (1958).
109. *Ibid.*
110. Leland v. Allen, 5 T.C. 1232 (1945).
111. Slater v. Commissioner, 222 F.2d 470 (2d Cir. 1955), *reversing* 21 P-H Tax Ct. Mem. 212 (1952).
112. INT. REV. CODE of 1954, § 1301(a).
113. Treas. Reg. § 1.1301-2(d) (1958).
114. Treas. Reg. § 1.1301-2(d)(1)(i) (1958).
115. Treas. Reg. § 1.1301-2(d)(1)(iv) (1958).
116. Treas. Reg. § 1.1301-2(d)(ii) (1958).
117. Treas. Reg. § 1.1301-2(c) (1958).
118. Treas. Reg. § 1.1301-2(d)(1)(iii) (1958). In determining what the increase

The alternative tax is the sum of these increases plus the tax computed for the year with the omission of the amounts received for the long-term employment.[119] The tax is the lesser of this amount and the tax computed without regard to Section 1301.[120]

If a partnership receives compensation for a qualifying long-term employment, each member is entitled to the benefits of Section 1301, provided that he has been a partner continuously for thirty-six months or for the entire period of the "employment" preceding the receipt of compensation, whichever is shorter.[121] For this purpose only, employment by the partnership immediately prior to becoming a partner is considered being a partner.[122] The Regulations[123] indicate the application of Section 1301 where an attorney begins an employment as an individual and then becomes a member of a partnership which continues the employment. In all applications of Section 1301 to a partner, it is immaterial whether or not he ever performed any duties (as a partner or as a former employee) with respect to the employment.[124]

B. DEDUCTION ITEMS

1. *Timing of Deductions.* Because of the graduated income tax rates for individual taxpayers,[125] an item of deduction is ordinarily worth more in a year of high income than in a year of low income. If an attorney expects to have higher income in a future year, he should consider deferring some of his deductions to that year.[126] He may do this by deferring purchase of depreciable property and by putting off payment[127] of deductible expenses. Conversely, if the present taxable year shows higher income than is expected in future years, the attorney should consider accelerating his purchases of depreciable property, choosing[128] methods of depreciation which will result

in tax would be for prior years, adjustments must also be made to any amounts depending upon gross income, adjusted gross income, or taxable income, such as the amount of nondeductible medical expenses, the limitation on charitable deductions, and net operating loss and capital loss carryovers. Treas. Reg. § 1.1301-2(d)(2) (1958).

119. Treas. Reg. § 1.1301-2(d)(1)(iv) (1958).

120. *Ibid.*

121. INT. REV. CODE of 1954, § 1301(c); Treas. Reg. § 1.1301-2(e)(1) (1958).

122. INT. REV. CODE of 1954, § 1301(c); Treas. Reg. § 1.1301-2(e)(4) (1958).

123. Treas. Reg. § 1.1301-2(e)(3) (1958).

124. Treas. Reg. § 1.1301-2(e)(1) and (4) (1958).

125. INT. REV. CODE of 1954, § 1.

126. In deciding whether to defer deductions and to what extent, he should consider the importance to him of the immediate tax reduction and of the lost earnings on this amount, the degree of likelihood that the high earnings will materialize in a future year and the possible application of the rules relating to long-term employment, INT. REV. CODE of 1954, § 1301.

127. If he is on the cash basis, see Part I B, p. 84 *supra.*

128. See Part II B7, p. 95 *infra.* In arriving at a decision, consideration should be given to the effects of a particular method of depreciation on all years to which the method will be applicable.

in high first year deductions, and paying as many expenses as possible that are currently deductible.

An attorney will have his tax reduced by marrying and filing a joint return if his spouse has no gross income.[129] Therefore, such an attorney might bunch his deductions in the year before his marriage.[130]

2. *Deduction for Payment of Client's Obligation or Expense.*

(a) Deduction as Business Expense. An attorney may be able to deduct as an "ordinary and necessary" business expense[131] amounts voluntarily paid on account of a client's obligation, if he has expressly or impliedly assumed that obligation as an ordinary and necessary part of rendering legal services.[132] In *C. Doris H. Pepper*,[133] a law firm had arranged for loans (from other than institutional investors) for a client who was later discovered to be a fraud. The lawyers repaid the lenders from their own funds and were permitted to deduct these amounts as a business expense. The entire transaction was held to have arisen out of the firm's trade or business,[134] because finding financing for clients is often a regular part of an attorney's practice and was in fact a small part of this firm's practice. In holding that the payment of the creditors was "ordinary and necessary," the court observed that "the expenditures . . . were essential to the very continuance of the petitioners' practice, for the protection of their means of livelihood."[135] Similarly, if an attorney fails to protect his client's interests properly, he may deduct his cost of paying the client's losses or expenses resulting from such failure.[136]

(b) Deduction for Discharge of Guarantee of Debt. If a noncorporate client borrows money for use in his trade or business, and his attorney guarantees the debt, then a payment by the attorney on account of his guarantee is fully deductible as a business bad debt as long as the debtor's obligation to the lender is otherwise worthless at the time of the attorney's payment.[137] If the guaranteed debt is a corporate obligation, then unless the guarantee or payment is an ordinary and necessary part of the attorney's

129. INT. REV. CODE of 1954, §§ 1(a), 2(a), 151(b).

130. Whether or not an attorney should marry is beyond the scope of this article, as it depends upon a number of variables, some of which are only remotely related to federal income taxes.

131. INT. REV. CODE of 1954, § 162(a).

132. C. Doris H. Pepper, 36 T.C. No. 88 (1961); Friedman v. Delaney, 171 F.2d 269, 273 (1st Cir. 1948) (concurring opinion) (dictum), *cert. denied*, 336 U.S. 936 (1949).

133. *Supra* note 132.

134. As required under INT. REV. CODE of 1954, § 162(a).

135. C. Doris H. Pepper, *supra* note 132, at —, 1961 P-H TAX CT. REP. & MEM. DEC. ¶ 36.88, at 656.

136. Henry F. Cochrane, 23 B.T.A. 207 (1931).

137. INT. REV. CODE of 1954, § 166(f); Treas. Reg. § 1.166-8 (1959). The section is applicable regardless of the guarantor's relationship or lack of relationship to the debtor.

profession,[138] the payment is considered to be a nonbusiness bad debt loss,[139] which is treated like a short-term capital loss.[140]

(c) Deduction as Bad Debt Generally. If an attorney advances amounts for a client and the client is obligated to reimburse the attorney, then the attorney may deduct as a business bad debt any such debt that becomes wholly or partially worthless[141] during the taxable year,[142] but not debts that are merely "doubtful" as to collection.[143]

3. *Traveling Expenses.* An attorney's traveling expenses[144] are nondeductible personal expenses unless they qualify as trade or business expenses or expenses for the production of income, or unless they are otherwise deductible as charitable contributions or medical expenses.[145]

An attorney's transportation expenses (which do not include meals and lodging) are deductible if they are ordinary and necessary expenses paid in carrying on his trade or business.[146] While ordinarily his cost of transportation between a business location and his home (or any other nonbusiness location) is not deductible,[147] he may deduct his transportation costs for a business trip to a location away from the metropolitan area in which his office is located, even if he goes directly from home and even if he is not away from home overnight.[148] Traveling expenses, which include all meal and lodging expenses, are deductible[149] if incurred while the attorney is away from home in the pursuit of his profession.[150] "Away from home" means in this context away from home overnight.[151]

If an attorney travels to a destination for both business and nonbusiness activities, then his travel expenses to and from such destination are deducti-

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138. *Supra* p. 90.

139. Treas. Reg. § 1.166-8(b) (1959).

140. INT. REV. CODE of 1954, § 166(d)(1)(B); Treas. Reg. § 1.166-5(a)(2) (1959).

141. For factors in determining worthlessness of a debt, see Treas. Reg. § 1.162-2 (1959).

142. INT. REV. CODE of 1954, § 166(a).

143. Reginald G. Hearn, 36 T.C. No. 69 (1961).

144. Traveling expenses include transportation costs, meals and lodging. Treas. Reg. § 1.162-2(a) (1958).

145. Treas. Reg. § 1.262-1(b)(5) (1958).

146. INT. REV. CODE of 1954, § 162(a); see Rev. Rul. 55-109, 1955-1 CUM. BULL. 261.

147. Lenke Marot, 36 T.C. No. 23 (1961); Clarence J. Sapp, 36 T.C. No. 83 (1961); Treas. Reg. § 1.262-1(b)(5) (1958); see Rev. Rul. 55-109, *supra* note 146.

148. See Rev. Rul. 55-109, 1955-1 CUM. BULL. 261, 262.

149. To the extent that the expenses are ordinary and necessary in relation to the attorney's profession, INT. REV. CODE of 1954, § 162(a).

150. INT. REV. CODE of 1954, § 162(a)(2). A comparable rule applies where the trip away from home is in connection with the management of property held for income or for any other purpose indicated in INT. REV. CODE of 1954, § 212. E. M. Godson, 15 P-H Tax Ct. Mem. 614 (1946).

151. Al J. Smith 36 T.C. 861 (1960). A possible exception to this rule, Williams v. Patterson, 286 F.2d 373 (5th Cir. 1961), is inapplicable to attorneys.

ble only if the trip is primarily for business purposes.[152] However, if the attorney would have had to make the trip later to accomplish the business purposes that he did take care of, some of his traveling expenses to the destination may be deducted.[153] In any event, an attorney may deduct expenses incurred solely for business reasons, such as for a side trip solely for business.[154]

Where an attorney's evidence of expenditures is incomplete, but it appears that some deductible expenses were incurred, the court may estimate the amounts deductible, resolving any doubts against the taxpayer.[155] But if the attorney fails to produce any evidence to guide the court in making an allocation between business and nonbusiness expenses, none of the expenses will be deductible.[156]

An attorney's deductible traveling and transportation expenses are subtracted from his gross income to determine his adjusted gross income[157] and he may use the standard deduction in determining his taxable income.[158]

4. *Entertainment Expenses and Social Club Fees.* The propriety of an attorney's entertaining prospective clients and the deductibility of his expenses were considered in interesting detail in *Robert R. Williams, Jr.*[159] To cope with the serious problem of rehabilitating his law practice following his discharge from the Navy, Williams embarked upon a deliberate, organized entertainment campaign to make as many contacts as he could with lawyers, adjusters, and business men who might refer business to him or become clients.[160] On his tax return, he deducted 1,300 dollars for 1948 and 1,450 dollars for 1949 for this and related entertainment expenses and for business gifts. The court held that to the extent these expenditures were reasonably calculated to maintain and increase his practice, they were deductible as ordinary and necessary business expenses.[161] Williams was found

152. Treas. Reg. § 1.162-2(b)(1) (1958). Whether expenses incurred in attending a convention are deductible depends on the facts of each case. Treas. Reg. § 1.162-2(d) (1956); Robert R. Williams, Jr., *supra* note 82.

153. Robert R. Williams, Jr., *supra* note 82 (Hopedale trip).

154. Treas. Reg. § 1.162-2(b)(1) (1958).

155. Cohan v. Commissioner, 39 F.2d 580 (2d Cir. 1930).

156. Robert R. Williams, Jr., *supra* note 82 (Miami Trip).

157. INT. REV. CODE of 1954, § 62(1) and (2)(B) and (C).

158. INT. REV. CODE of 1954, § 63(b). This is now true even if the attorney incurs these expenses as an employee. INT. REV. CODE of 1954, § 62(2)(B) and (C). Under the Internal Revenue Code of 1939, an employee's traveling expenses while away from home, but not his local transportation expenses, could be deducted in addition to the standard deduction. INT. REV. CODE of 1939, § 22(n)(3); Chester C. Hand, Sr., 16 T.C. 1410 (1951).

159. *Supra* note 82.

160. *Id.* at 317. During 1948 and 1949, every Tuesday night he and his wife entertained two to four couples at their home, with the understanding that no person would be invited back more than once in six months. In addition, he and his wife gave a large cocktail party in the spring of each year, to which they invited over 300 guests. *Id.* at 314.

161. *Id.* at 317. The court observed, "Such practices are hardly novel or unusual,

to have satisfied his burden of proof by establishing a pattern, proving substantial expenditures, demonstrating results,[162] and giving enough details to permit the court to make a reasoned determination of the allowable deduction.[163] Making allowance for the nonbusiness motives for the entertaining, the court allowed the deduction of one half of the amounts claimed.

No amount may be deducted for amounts spent on an attorney's own meals while entertaining, except to the extent that it can be shown that the expenditure was greater than the taxpayer would have made if there were no business considerations.[164] If he does not show evidence on this point, the *Cohan*[165] rule will not be applied.[166]

Annual dues at social clubs may be partially deductible where membership has a purpose reasonably related to the attorney's practice.[167] The court will not upset the Commissioner's determination of the allowable portion of the expenses in the absence of evidence of specific instances of business-related activities.[168] Initiation fees, having an indefinite useful life, must be capitalized and are not deductible as business expenses.[169] Club assessments for capital improvements are also not deductible as expenses, but these may be depreciable over the life of the improvements.[170] Assessments for current operating expenses are presumably deductible currently.[171]

5. *Reimbursed Expenses.* An attorney incurring expenses or making advances which are to be reimbursed by his client treats these transactions as loans. He may not deduct the amounts he advances,[172] and when he

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particularly in those professions in which soliciting or advertising are forbidden by ethical concepts." *Id.* at 318.

162. "It is clearly unrealistic to require that each particular expenditure be somehow attributable to a particular item of future business or the establishment of a particular future business relationship." *Id.* at 318. This appears to be an easier test to meet than that indicated by the Internal Revenue Service in a letter relating to doctors' entertainment expenses from the District Director of Internal Revenue for Mississippi, dated June 13, 1958, 4 P-H 1960 FED. TAX SERV. ¶ 54,636, 6 CCH 1959 STAND. FED. TAX REP. ¶ 6575, which implies that physicians in private practice may not deduct the cost of entertaining anyone other than other doctors, who might make referrals, and patients, and that a general expectation to get referrals or patients as a result of entertaining is not enough.

163. Robert R. Williams, Jr., *supra* note 82, at 318.

164. Gerard F. Re, 24 P-H Tax Ct. Mem. 693 (1955); Richard A. Sutter, 21 T.C. 170, 173 (1953) (dictum).

165. Cohan v. Commissioner, *supra* note 155. For a case where the Cohan rule was generously applied, see James Schultz, 16 T.C. 401 (1951).

166. Richard A. Sutter, 21 T.C. 170 (1953); John W. Scott, 25 P-H Tax Ct. Mem. 1169 (1956).

167. Long v. Commissioner, 277 F.2d 239 (8th Cir. 1960); Reginald G. Hearn, *supra* note 83.

168. *Ibid.*

169. Mercantile National Bank at Dallas, 30 T.C. 84 (1958).

170. Oswego Falls Corporation, 46 B.T.A. 801 (1942).

171. 2 CCH 1961 STAND. FED. TAX REP. ¶ 1338.2147.

172. Reginald G. Hearn, *supra* note 83; Henry F. Cochrane 23 B.T.A. 207 (1931).

receives repayment it is not included in his income.[173] If the client's obligation to repay becomes wholly or partially worthless, then the amount charged off may be deducted as a bad debt.[174] If the client can pay, but the attorney forgives the debt to keep the client, the amount may be deductible[175] as a loss[176] or as a business expense.[177] Where the client disputes his obligation to repay, the expenses are deductible when incurred[178] and presumably any reimbursement received is includible in income.

Expenses incurred by an attorney as an employee, under a reimbursement arrangement with his employer, must be treated somewhat differently. Since these amounts are deductible when paid,[179] it follows that the reimbursement must be included in taxable income, and in the year in which it is received.[180] This may result in a distortion of an attorney's income if he advances a substantial amount in one taxable year and is reimbursed by his employer in a different taxable year.

If an attorney who is a partner incurs expenses which are to be reimbursed by the partnership,[181] then he should treat the expenses as a loan to the partnership which is repaid upon reimbursement, in accordance with the discussion above.[182] The treatment accorded employees' reimbursed expenses is inapplicable because that treatment follows solely from Section 62 (2)(A) which relates exclusively to employees, and because the Regulations[183] expressly apply only to employees. Thus there appears to be no need for an attorney to report on his return the details concerning reimbursements, unless he wants a deduction for unreimbursed expenses, such as for deductible automobile expenses that exceed his reimbursements.[184]

If an attorney who is a partner in a firm incurs business expenses in

173. Henry F. Cochrane, *supra* note 172.

174. INT. REV. CODE of 1954, § 166; Reginald G. Hearn, *supra* note 83 (dictum).

175. *Accord,* Lab Estates, Inc. 13 T.C. 811 (1949), *acq.*, 1950-1 CUM. BULL. 3.

176. Under INT. REV. CODE of 1954, § 165.

177. Under INT. REV. CODE of 1954, § 162(a).

178. Pittsburgh Industrial Engineering Co., 19 P-H Tax Ct. Mem. 1038 (1950); Electric Tachometer Corp., 37 T.C. No. 20 (1961).

179. INT. REV. CODE of 1954, § 62 (2)(A). While Treas. Reg. § 1.62-1(b) (1957) states that § 62 creates no new deductions but merely specifies which otherwise allowable deductions are used to compute adjusted gross income, the matching of payments and reimbursements required, apparently on an annual basis, by Treas. Reg. § 1.162-17(b) and (c) (1958), differs from the treatment of reimbursed expenses of a non-employee. This different treatment seems explainable only by regarding § 62 (2)(A) as creating a deduction for reimbursable expenses for the current taxable year not otherwise allowable.

180. INT. REV. CODE of 1954, § 451(a); Treas. Reg., § 1.451-1(a) (1957).

181. Whether or not the partnership is to be reimbursed by a client.

182. See p. 93 *supra*. He is treated in this transaction as if he were not a partner. INT. REV. CODE of 1954, § 707(a); Treas. Reg. § 1.707-1(a) (1956).

183. Treas. Reg. § 1.162-17 (1958).

184. See Robert R. Williams, Jr., *supra* note 82, where an attorney was permitted to deduct the cost of his business expenses to the extent that they exceeded the amounts reimbursed by a partnership consisting of himself and his father.

connection with the firm's business, then, whether or not he is reimbursed by the firm, these amounts are not deductible by him on his return, but are deductible only by the firm in computing its partnership income.[185]

6. *Education Expenses.* An attorney may deduct the expenses[186] of education (including research activities) undertaken primarily to maintain or improve the skills required in his existing professional status.[187] He may also deduct the expenses of any education required by his employer for the retention of his existing status.[188] However, he may not deduct expenses of education undertaken primarily to obtain a new position or a substantial advancement of position, or for any non-professional purposes.[189]

An attorney practicing as a sole practitioner or as a partner deducts these costs of education in determining his adjusted gross income,[190] and may, in addition, take the standard deduction under Section 141 to determine his taxable income.[191]

7. *Depreciation.* "The allowance for depreciation is primarily intended to provide a non-taxable fund to restore property used in producing income at the end of its useful life, when its capacity to produce income has ceased."[192]

"A deduction for depreciation is allowable if the property used in the trade or business of taxpayer [*sic*] is shown to have a useful life for a limited period in the taxpayer's business or in the production of his income.

185. Estate of Charles O. Gunther, Jr., 23 P-H Tax Ct. Mem. 913 (1954); Western Construction Company, 14 T.C. 453, 471 (1950); Hiram C. Wilson, 17 B.T.A. 976 (1929).

186. Including tuition, travel, meals, and lodging to the extent that these expenses are incurred primarily to obtain education qualifying for deduction. Treas. Reg. § 1.162-5(d) (1958).

187. Treas. Reg. § 1.162-5(a) (1958); Coughlin v. Commissioner, 203 F.2d 307 (2d Cir. 1953). See Bistline v. United States, 145 F. Supp. 802 (E.D. Idaho 1956), where an attorney's tuition and hotel expenses in attending a federal tax course were deductible as business expenses, except to the extent that he was reimbursed therefor.

188. Treas. Reg. § 1.162-5(a)(2) (1958).

189. Treas. Reg. § 1.162-5(b) and (e), Example (2) (1958). *Compare* Arnold Namrow, 33 T.C. 419 (1959) (psychiatrists denied deduction for cost of training to become psychoanalysts) *with* John S. Watson, 31 T.C. 1014 (1959) (physician using psychiatric methods in diagnosing and treating patients in his general practice may deduct costs of training in analysis and techniques of psychiatry to be used in his general practice). However, differences between the general practice of an attorney and the general practice of a physician may lead to different results in otherwise comparable cases.

190. INT. REV. CODE of 1954, § 62 (1).

191. Rev. Rul. 60-97, 1960-1 CUM. BULL. 69. An employed attorney may deduct his transportation, meals, and lodging expenses (if away from home overnight), INT. REV. CODE of 1954, § 62 (2)(B), or his transportation expenses alone (if not away from home overnight), INT. REV. CODE of 1954, § 62 (2)(C), in determining his adjusted gross income, but his expenses for tuition, books, and similar items may be deducted only if he does not take the standard deduction.

192. 4 MERTENS, FEDERAL INCOME TAXATION § 23.01 (1960).

The limited period need only be estimated with reasonable accuracy."[193]

An attorney's property subject to depreciation includes tangible property used in his profession (or held for the production of income), but not inventories or land.[194] He may depreciate desks, bookcases, typewriters and other office equipment and furnishings. He may also depreciate books, texts, and reports to be used for more than one year,[195] but no deduction is allowable if he cannot show the cost of the property and when it was purchased.[196] He may take depreciation deductions for his automobile to the extent he uses it in his profession.[197] An attorney's home does not give rise to depreciation deductions, even if he conducts some business there,[198] unless he has a room used primarily for his profession.[199] Intangible property is also depreciable, if its useful life is limited to a period that can be estimated with reasonable accuracy.[200] An agreement not to compete is subject to depreciation if it is limited in time and if the taxpayer's cost is determinable.[201] If an attorney purchases the files of a retiring or deceased attorney and can show the price allocated to these files and that the files would be useful for a limited period only, then he may be able to depreciate the cost of the files.[202]

The timing of the depreciation deductions within the property's useful life is, within limits, subject to the attorney's determination. If an attorney purchases depreciable tangible personal property, which has a useful life of six years or more, then in the year in which he would otherwise first be entitled to a depreciation deduction he may elect to take a special depreciation deduction equal to 20 percent of the cost of the property.[203] In the case of a husband and wife filing a joint return, the deduction is applicable only to the first 20,000 dollars of cost of such property.[204] In the case of all other eligible

193. Chester R. Johnson, Jr. v. United States, 61-1 U.S. Tax Cas. 79,674, 79,676 (W.D. Tex. 1961).

194. INT. REV. CODE of 1954, § 167(a); Treas. Reg. § 1.167(a)2 (1956).

195. Louis Boehm, 35 B.T.A. 1106 (1937).

196. Morris Schwartz, 1961 P-H TAX CT. REP. & MEM. DEC. ¶ 61,144; Louis Boehm 35 B.T.A. 1106 (1937).

197. Robert R. Williams, Jr., *supra* note 82.

198. See Treas. Reg. § 1.262-1(b)(3) (1958).

199. Morris Schwartz, 1961 P-H TAX CT. REP. & MEM. DEC. ¶ 61,144.

200. Treas. Reg. § 1.167(a)(3) (1956), as amended, T.D. 6452, 1960-1 CUM. BULL. 127. But only the straight line method of depreciation is permissible. INT. REV. CODE of 1954, § 167(b) and (c).

201. Standard Lumber & Hardware Co., 27 P-H Tax Ct. Mem. 683 (1958); see Simon Harris, 1961 P-H TAX CT. REP. & MEM. DEC. ¶ 61,035.

202. In Chester R. Johnson, Jr. v. United States, *supra* note 193, an obstetrician who purchased the patient records of a retiring obstetrician was allowed to depreciate the amount paid, because he showed that he paid $4.50 for each record which was reasonable because otherwise the doctor would have had to get the information by spending $30 worth of time with each patient for which he could not charge, and that the records had a limited useful life because of patients' mobility and limited child-bearing years.

203. INT. REV. CODE of 1954, § 179.

204. INT. REV. CODE of 1954, § 179(b).

taxpayers,[205] the limitation is 10,000 dollars of cost.[206] If an attorney elects to take the special deduction under Section 179, his basis for depreciation[207] is reduced by the amount of the special deduction, before the regular depreciation deductions are computed.[208]

An attorney may choose among several methods of depreciation. The straight-line method of depreciation is applied by starting with the adjusted basis of the property[209] and subtracting the salvage value,[210] which is the estimated proceeds that he will receive upon the sale of the property when it is no longer useful to him.[211] The balance is divided by the number of years of useful life, and the quotient is the depreciation deduction for each full year of use.[212] If less than a full year is involved (in the year of acquisition, the year of sale, or a "short period"[213] taxable year), then only a proportional part of the deduction is allowed.[214] Assets depreciated on the straight-line method may be treated as group, classified, or composite accounts.[215]

Other methods of depreciation permit the depreciable cost to be deducted more rapidly than the straight-line method, although under all methods the total amounts deductible over the years will be the same (adjusted basis less salvage value).[216] These methods may be used only in the case of tangible property with a useful life of three years or more, constructed or acquired unused by the taxpayer after 1953.[217] Different methods may be used for different assets.[218] Whether an attorney would want to use accelerated methods of depreciation (and the special deduction allowed by Section 179) would depend upon a number of factors, including his present tax bracket, his expected tax bracket in future years, his need for the increased funds that would result from reduced current taxes, and the expense of any increased bookkeeping or accounting required.

8. *Charitable Contributions.* The value of legal or other services con-

205. The special depreciation deduction is not available to trusts. INT. REV. CODE of 1954, § 179(d)(4). For special rules in the case of an estate and its heirs, legatees, and devisees, see INT. REV. CODE of 1954, § 179(d)(5), and Treas. Reg. § 1.179-2 (b) (1960).

206. INT. REV. CODE of 1954, § 179(b).

207. INT. REV. CODE of 1954, § 167(f).

208. INT. REV. CODE of 1954, § 179(d)(8).

209. INT. REV. CODE of 1954, §§ 167(f), 1011.

210. Treas. Reg. 1.167(b)-1(a) (1956).

211. Treas. Reg. § 1.167(a)-1(c) (1956), as amended, T.D. 6507, 1960-2 CUM. BULL. 91.

212. Treas. Reg. § 1.167(b)-1(a) (1956).

213. INT. REV. CODE of 1954, § 443(a).

214. Treas. Reg. § 1.167(b)-1(b), Example (1) (1956).

215. Treas. Reg. § 1.167(b)-1(b), Examples (2) and (3) (1956).

216. Treas. Reg. § 1.167(b)-0(a) (1956).

217. INT. REV. CODE of 1954, § 167(b) and (c).

218. Treas. Reg. § 1.167(b)-0(c) (1956).

tributed to charitable institutions is not deductible.[219] However, unreimbursed traveling expenses incurred while away from home in connection with such gratuitous services are deductible as charitable contributions.[220] Query whether an attorney may deduct as a charitable contribution the wages or salary paid to his employee on account of time spent by the employee in working for a charitable institution.

Dues paid to a charitable organization are not deductible if the payment bestows upon the payor certain benefits, such as journals, free use of facilities, and similar rights.[221] However, these dues might qualify as ordinary and necessary business expenses[222] or perhaps as ordinary and necessary expenses paid for the production of income.[223] The purchase price of theater tickets or other privileges or property bought from a charitable organization is deductible only to the extent that the price paid exceeds the fair market value of the privilege or property received.[224]

9. *Forwarding Fees.* Some question exists whether an attorney paying a forwarding fee[225] may deduct it as a business expense.[226] In order to qualify as a business expense, the payment would have to be "ordinary"[227] ("normal, usual, and customary in the profession and in the community"),[228] "necessary"[229] ("appropriate and helpful in obtaining business"),[230] and of such a nature as would not "frustrate sharply defined National or State policies evidenced by a governmental declaration proscribing particular types of conduct."[231] Whether a payment of a forwarding fee meets these requirements may depend upon the facts of the particular case.

The requirement that the payment must not frustrate sharply defined national or state policies is based upon the decision in *Lilly v. Commis-*

219. Treas. Reg. § 1.170-2(a)(2) (1958); O.D. 712, 3 CUM. BULL. 188.

220. Treas. Reg. § 1.170-2(a)(2) (1958); Rev. Rul. 55-4, 1955-1 CUM. BULL. 291.

221. Rev. Rul. 55-565, 1954-2 CUM. BULL. 95.

222. INT. REV. CODE of 1954, § 162(a); Rev. Rul. 55-565, *supra* note 221.

223. INT. REV. CODE of 1954, § 212.

224. See Harold DeJong, 38 T.C. No. 89 (1961); *Cf.* Rev. Rul. 56-120, 1956-1 CUM. BULL. 514 (admissions tax); Rev. Rul. 61-126, 1961 INT. REV. BULL. No. 42, at 20.

225. In this discussion, a forwarding fee means a payment by an attorney, who performed services for a client, to another attorney who rendered no services to the client but sent the client to the attorney paying the forwarding fee.

226. INT. REV. CODE of 1954, § 162(a).

227. INT. REV. CODE of 1954, § 162(a).

228. I. T. 4096, Rev. Rul. 18-13910, 1952-2 CUM. BULL. 91 (dealing with fee splitting by a surgeon with a referring physician). This requirement of the ruling appears to impose a greater burden on the person desiring to deduct the forwarding fee than is imposed in the case relied on by the ruling, Lilly v. Commissioner, 343 U.S. 90, 93, 97 (1952), where the test seemed to be whether the practice was common in the profession in that area only.

229. INT. REV. CODE of 1954, § 162(a).

230. I. T. 4096, *supra* note 228.

231. *Ibid.*

sioner,[232] which distinguishes between sharply defined national or state policies and the attitudes of organized professional groups.[233]

Canon 28 of the Canons of Professional Ethics of the American Bar Association provides:

> *It is disreputable* to hunt up defects in titles or other causes of action and inform thereof in order to be employed to bring suit or collect judgment, or *to breed litigation by seeking out* those with claims for personal injuries *or those having any other grounds of action in order to secure them as clients*, or to employ agents or runners for like purposes, *or to pay or reward, directly or indirectly, those who bring or influence the bringing of such cases to his office* . . . . (Emphasis added.)

Canon 34 provides:

> No division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility.

The purpose of Canon 34 is to condemn forwarding fees.[234]

In Pennsylvania, the Canons of Professional Ethics of the American Bar Association have been cited as authority for disbarment.[235] The local bar associations play an official part in disbarment proceedings,[236] and the bar's investigating committee may be given the power to issue subpoenas and administer oaths.[237] However, whether the requirements of the Canons of Ethics and the policies of bar associations constitute sharply defined national or state policies proscribing forwarding fees has not been decided.[238]

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232. *Supra* note 228.

233. *Id.* at 97.

234. DRINKER, LEGAL ETHICS 186 (1954). Where a client specifically agrees that the forwarding lawyer should receive a forwarding fee, the Canon is not violated. *Id.* at 188.

235. See *In re* Disbarment Proceedings, 321 Pa. 81, 95, 184 Atl. 59, 65 (1936).

236. See *In re* Disbarment Proceedings, *supra* note 235; Samuel W. Salus's Case, 321 Pa. 103, 184 Atl. 69 (1936).

237. PA. STAT. ANN. tit. 17, § 1665 (Supp. 1960), *In re* Disbarment Proceedings, *supra* note 235.

238. The line of cases permitting exclusion from gross income of rebates to customers or their employees, *e.g.*, Marlon E. Pew, Jr., 1961 P-H TAX CT. REP. & MEM. DEC. ¶ 61,264; Harmony Dairy Co., 1960 P-H TAX CT. REP. & MEM. DEC. ¶ 60,109; Rosedale Dairy Co., 26 P-H TAX CT. MEM. 951 (1957); Pittsburgh Milk Co., 26 T.C. 707 (1956), *nonacq.*, 1959-1 CUM. BULL. 6, would seem to be inapplicable to forwarding fees of which the client is ignorant, because these cases treat the amounts refunded as deposits to be returned in all events, Pittsburgh Milk Co., *supra* at 716. There is no agreement that the portion of the fee paid by the client which is equal to such a forwarding fee is to be returned to the client, nor is there any agreement with the client that that portion will be paid to another. The fee belongs entirely to the attorney, to be used by him as he sees fit, and it is all part of his gross income. However, where the client pays a fee to an attorney with the understanding that a part is to be paid to another, then the first attorney is merely a conduit or agent for the client, and the cases cited in this note would appear to be relevant.