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TAX RELIEF FOR PROFESSIONAL SERVICE ORGANIZATIONS

INTRODUCTION

The Internal Revenue Code provides: "[T]he term "corporation" includes associations, joint stock companies and insurance companies."[1] This definition extends the advantages and disadvantages of corporate income tax law to business forms other than true corporations. Corporate tax status, for reasons hereinafter discussed, is particularly attractive to professional service organizations. Since many states prohibit the corporate practice of law and medicine, professional service organizations have most often attempted to obtain corporate tax status by qualifying as "associations."[2] After examining the advantages and disadvantages of corporate status and comparing the tax alternative available upon failure to qualify as a corporation, this Comment will trace the definition of "association" as originally formulated and subsequently modified by the Treasury Department in its attempt to exclude professional service organizations. Emphasis will be given to recent district court cases which seem to thwart that attempt.

INCIDENTS OF CORPORATE STATUS

The quest by professional service organizations for corporate tax treatment can be better understood after examining the stakes involved. The major tax disadvantage of corporate status is the so-called "double taxation." Income is taxed both to the corporation as earned and to the shareholder as distributed. An important advantage of corporate status is the availability of the profit-sharing and pension plans described in the Internal Revenue Code.[3] Since these profit-sharing and pension plans are limited to "employees,"[4] a person must be the member of a business organization that can given him employee status in order to utilize them. Self-employed persons and members of a partnership are not "employees" as are persons who work for a corporation.

Corporate status is particularly attractive for professional service organizations. They can substantially avoid double taxation by

1. INT. REV. CODE of 1954 § 7701(a)(3) [hereinafter cited as "IRC"].
2. "Association" is defined as Treas. Reg. § 301.7701-2(a), T.D. 6797, 1965-1 CUM. BULL. 553 as an organization which possesses a majority of corporate characteristics. This will be discussed in detail *infra*.
3. IRC §§ 401-07.
4. IRC § 401(a).

withdrawing corporate earnings as salaries, which are deductible by the corporation as a business expense as long as they are reasonable.[5] Thus, the only tax imposed is at the shareholder level. With the double taxation disadvantage minimized, the members of a "corporate" professional service organization can reap full benefit from the employee profit-sharing and pension plans.

Under a combined qualified profit-sharing and pension plan, an employer can place a maximum of twenty-five per cent of the compensation paid to an employee in the taxable year into retirement benefits for that employee and still deduct that amount as part of the employee's salary.[6] However, receipt of these funds by the employee is considered postponed and they are not taxed to him until actually distributed or made available to him.[7] Thus, the employee can withdraw the funds upon retirement, taking advantage of his presumably lower tax rate and double personal exemptions. In addition, the eventual distribution of these funds will receive capital gains treatment if the total distributions payable are made within one year and are made on account of the employee's death, retirement or other separation from the service of the employer.[8] The tax savings involved can be substantial. A high income bracket employee can have twenty-five per cent of each year's compensation set aside and withdraw it upon retirement, either in periodic payments at a much lower tax rate or in a lump sum at capital gains rates. Also, these qualified profit-sharing and pension plans receive favorable federal estate and gift tax treatment. If the employee dies without withdrawing the funds, any payment receivable by a beneficiary under the qualified plan is generally excluded from the employee-decedent's gross estate.[9] The appointment by the employee of a beneficiary to receive payments under the qualified plan after the employee's death is not considered a transfer by the employee for federal gift tax purposes.[10]

Until recently, self-employed persons and members of partnerships, not being "employees," were denied these retirement benefits. In 1962, Congress passed the Self-Employed Individuals Tax Retirement Act,[11] commonly known as the Keogh Plan, which

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5. IRC § 162(a)(1).
6. IRC § 404(a).
7. IRC § 402(a)(1).
8. IRC § 402(a)(2).
9. IRC § 2039(c).
10. IRC § 2517.
11. Pub. L. No. 87-792, 87th Cong., 2d Sess. (Oct. 10, 1962). The provisions of the Keogh Plan have been codified in the Internal Revenue Code

grants limited retirement benefits to non-employees. But this concession fell far short of the qualified retirement benefit plans available to employees. The Keogh Plan has a maximum allowable contribution of ten per cent of the person's income or $2,500, whichever is the lesser amount.[12] This compares poorly with the twenty-five per cent maximum under the employee plans which have no dollar amount limitation. If the ten per cent or $2,500 maximum is exceeded, the contributions made on behalf of a person are thrown back into his gross income for that year.[13] Another limitation in the Keogh Plan is that only fifty per cent of the maximum allowable contribution is deductible from current income.[14] The maximum benefit to be derived from this plan is thus limited to $1,250 per year (fifty per cent of the $2,500 maximum allowable contribution). Again, this limitation has no counterpart in the employee plans. Also, funds contributed under the Keogh Plan can only be distributed while the distributee is between the ages of fifty-nine and one-half years[15] and seventy and one-half years[16] or the distributee will be penalized.[17] There is no comparable age limitation in the employee plans. The Keogh Plan does not grant capital gains treatment for lump sum distributions as do the employee plans. Finally, unlike the employee plans, the Keogh Plan does not qualify for favorable estate and gift tax treatment.

If a professional service organization can achieve corporate status, its members can avail themselves of the qualified profit-sharing and pension plans. If not, its members are left with the severely limited Keogh Plan. With these benefits at stake, the battle by professional service organizations for association status is understandable.

HISTORY

Since many states prohibit as a matter of public policy the corporate practice of law and medicine, professional service organizations have most often sought to obtain corporate status by qualifying as an association as that term is used in the Internal Revenue Code definition of a corporation.[18] Association was defined in *Morrissey v. Commissioner*[19] and subsequent income tax regulations[20] as an organization which possesses more corporate

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along with the other profit-sharing and pension plan sections. See IRC § 401-05.

12. IRC § 401(e).
13. IRC § 401(e).
14. IRC § 404(a)(10).
15. IRC § 401(d)(4)(B).
16. IRC § 401(a)(9).
17. IRC § 72(M).
18. IRC § 7701(a)(3).
19. 296 U.S. 344 (1935).
20. Treas. Reg. § 301.7701-2(a), T.D. 6797, 1965-1 CUM. BULL. 553.

than non-corporate characteristics. The characteristics of a corporation are associates, an objective to carry on business and divide the gains therefrom, continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests.[21] One year after *Morrissey*, in *Pelton v. Commissioner*,[22] an unincorporated medical group was treated as an association. In that case, the commissioner was arguing for association status and the medical group was seeking to avoid it. But from this case on, the Internal Revenue Service has generally opposed association status for professional service organizations.

United States v. Kitner[23] was a landmark case decided in 1954. In that case an unincorporated group of doctors was seeking association status and its accompanying retirement benefits. Since, at this time, few states had provisions for professional corporations or associations, the IRS argued that the state labels attached to these organizations should be dispositive. The court, however, reasoned that federal standards should be applied to promote uniformity in the income tax law. Thus, in *Kitner* and a subsequent case,[24] professional service organizations were granted association status since they possessed more corporate than non-corporate characteristics.

In response to *Kitner*, the so-called "Kitner" regulations[25] were promulgated in 1960 providing that although federal standards must be met for association status, state law determines whether the organization does in fact possess these federally defined corporate characteristics.[26] This was a reasonably safe position for the IRS to take. At that time few states permitted professional service organizations to form anything but partnerships and limited partnerships which, of course, did not have the legal attributes under state law to satisfy the federally defined corporate characteristics.

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21. Treas. Reg. § 301.7701-2(a) (1965). This regulation provides that those characteristics common to both corporations and the organization in question are immaterial in determining whether that organization possesses a majority of corporate characteristics. Since associates and an objective to carry on a business for a profit are common to both partnerships and corporations, only the remaining four characteristics are material in determining whether a professional service organization qualifies as an association.
22. 82 F.2d 473 (7th Cir. 1936).
23. 216 F.2d 418 (9th Cir. 1954).
24. Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).
25. Treas. Reg. § 301.7701-2 T.D. 6503, 1960-2 CUM. BULL. 409.
26. Treas. Reg. § 301.7701-1(c) (1960).

The Treasury Department's reliance upon the legal relationship established by local law backfired when many states, sensitive to the plight of the professional service organizations, passed acts permitting the formation of professional service corporations and associations.[27] State law granted these new entities enough corporate characteristics to qualify them for association status under the Internal Revenue Code.[28]

The Treasury Department responded this time by amending the "Kitner" regulations in 1965.[29] The new regulations were specifically directed at professional service organizations and applied to incorporated as well as unincorporated organizations. Even if a professional service organization was organized as an ordinary business corporation under state law, it still could not get corporate tax treatment unless it had a majority of corporate characteristics.[30] While local law still determined the legal attributes of the organization, these attributes had to satisfy a stiffer federal definition of limited liability, centralization of management, free transferability of interests, and continuity of life than did other business organizations.[31] These more stringent corporate characteristics were:

(1) *Continuity of life*—In an ordinary business corporation, the right of a shareholder to share in the profits is not dependent upon participation in their production. But generally, professional service organizations require an employment relationship in order to share in profits. Thus, if state law or professional ethics require this employment relationship, a member of his estate must dispose of his interest when the employment relationship ceases. Under these circumstances, the continuing existence of the organization depends upon the agreement of the remaining members to purchase the departed member's interest or to employ his proposed successor. This is essentially different from the continuity of life possessed by an ordinary business corporation. Consequently, such a professional service organization lacks continuity of life.[32]

(2) *Centralization of management*—Even though a measure of central control may exist in a professional service organization, if the members retain traditional autonomy with respect to pro-

27. For a comprehensive compilation of the state acts see Snyder and Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L.Q. 613, 656-58, nn.148-54 (1963).

28. In 1961 Pennsylvania passed the Professional Association Act, PA. STAT. ANN. tit. 15, §§ 12601-19 (1967). That statute seems to grant all of the corporate characteristics as defined in the 1960 "Kitner" regulations except perhaps limited liability. See PA. STAT. ANN. tit. 15, § 12617 (1967).

29. Treas. Reg. § 301.7701-2 (1965).

30. Treas. Reg. § 301.7701-2(h)(1)(i) (1965).

31. Only four of the six corporate characteristics are relevant here since associates and an objective to carry on a business for a profit are common to both partnerships and true business corporations. See note 21 *supra*.

32. Treas. Reg. § 301.7701-2(h)(2) (1965).

fessional decisions and the traditional responsibility of a professional person to a client or patient, such an organization does not possess centralization of management.[33]

(3) *Limited liability*—A professional service organization possessed limited liability only if the personal liability of its members is no greater than that of shareholder-employees of an ordinary business corporation.[34]

(4) *Free transferability of interests*—If a professional service organization requires an employment relationship in order to share in profits, free transferability of interest exists only if a member may, without the consent of the other members, transfer both the right to share in profits and the right to an employment relationship.[35]

The professional association statutes which had been enacted by the states sufficiently limited professional organizations so that they were unable to meet these more stringent criteria for corporate tax status.[36] If the 1965 amendment of the "Kitner" regulations was strictly enforced by the courts, the hopes of professional service organizations for corporate tax status would be dashed. However, judicial reaction to the amendment has been hostile. The remainder of this Comment will consider the recent district court cases which strike down that amendment.

JUDICIAL ASSISTANCE FOR PROFESSIONAL GROUPS

In *Empey v. United States*,[37] a group of lawyers incorporated under Colorado law[38] brought an action in the district court for an income tax refund. They had paid their income tax as a partnership and were now claiming corporate tax status. The IRS, proceeding under the amended "Kitner" regulations, argued that because of the nature of the relationship between doctor and patient and lawyer and client, professional service organizations could not be taxed as corporations even if incorporated under

33. Treas. Reg. § 301.7701-2(h)(3) (1965).
34. Treas. Reg. § 301.7701-2(h)(4) (1965).
35. Treas. Reg. § 301.7701-2(h)(5)(i) 1965).
36. Pennsylvania's Professional Association Act, for example, does not confer centralized management or limited liability as defined in the 1965 amendment to the "Kitner" regulations. Thus, organizations operating thereunder would have, at the most, only two of the four corporate characteristics and would lack the requisite majority. PA. STAT. ANN. tit. 15, § 12606 and § 12617 (1967).
37. 272 F. Supp. 851 (D. Colo. 967) *aff'd*, 406 F.2d 157 (10th Cir. 1968).
38. The Supreme Court of Colorado, adopted a rule premitting lawyers to incorporate. COLO. SUP. CT. R. 265.

state law.[39] Regardless of whether they are incorporated under state law, professional service organizations must still meet the stringent corporate criteria of the amended "Kitner" regulations to obtain corporate tax status. The court rejected this argument and held that the attempt to tax an incorporated entity as a partnership was invalid as inconsistent with the Internal Revenue Code and the judicial interpretation thereof.[40] The Internal Revenue Code defines a partnership as ". . . a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business . . . is carried on. . . ."[41] The court said that this reference to unincorporated organizations necessarily excluded incorporated organizations.[42] Also, the contention of the IRS was inconsistent with the judicial interpretation of the Internal Revenue Code which had held that professional service organizations could be treated as corporations for tax purposes.[43] The court further strengthened its position by noting that Congress had taken no legislative action to repudiate this judicial construction.[44] The court concluded that the invalidity of the regulations entitled the taxpayer to corporate status and the refund was granted.

Although *Empey* held the 1965 amendment to the "Kitner" regulations (hereinafter regulation (h)) invalid as to incorporated professional service organizations, it did not discuss whether those more stringent corporate criteria were valid as to professional service organizations not incorporated under state law. The court in *Empey* assumed *arguendo* that the regulations were valid as to incorporated groups, but then stated that the group in question would still qualify for corporate tax treatment since it possessed a majority of corporate characteristics.[45] It is not clear, however, whether this result was reached under the more stringent standards of regulation (h) or the ordinary standards that apply to all other business organizations (hereinafter regulation (a)-(g)).

In *O'Neill v. United States*,[46] the district court again held that the Internal Revenue Code definition of partnership necessarily excluded the medical group in question since it was validly incorporated under state law. Although the statute under which this medical group was organized was called the Ohio Professional Association Act,[47] the purpose of that act was to permit professional

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39. 272 F. Supp. at 852.
40. *Id.* at 853.
41. IRC § 7701(a)(2).
42. 272 F. Supp. at 853.
43. United States v. Kitner, 216 F.2d 418 (9th Cir. 1954); Pelton v. Comm'r, 82 F.2d 473 (7th Cir. 1936); Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).
44. 272 F. Supp. at 853.
45. *Id.* at 854.
46. 281 F. Supp. 359 (N.D. Ohio 1968).
47. OHIO REV. CODE ANN. § 1785 (Baldwin Supp. 1966).

service organizations to incorporate.[48] It incorporated by reference the whole body of Ohio business corporation law.[49] The court was unable to find any material difference between professional service associations and ordinary business corporations other than the fact that only licensed doctors could be shareholders and services could be rendered only by licensed doctors.[50] The court therefore concluded that the medical group should be regarded as a corporation under Ohio law.[51] As a corporation, it was necessarily excluded from the Internal Revenue Code definition of partnership and any attempt to tax it as such must fail.

Once again in *O'Neill*, the organization in question was incorporated under state law and the court did not discuss the validity of regulation (h) as applied to unincorporated professional service organizations.

In *Kurzner v. United States*,[52] that question was apparently answered, at least in dicta. Again, the medical group in question was validly incorporated pursuant to the Florida Professional Service Corporation Act.[53] The court gave two grounds for granting this organization corporate tax status. First, since it did not fall under the Internal Revenue Code definition of partnership, it could not be taxed as such.[54] Second, the court moved to consider the corporate criteria set forth in regulation (h):

> It cannot be doubted that except for the most unusual circumstances, these criteria preclude all professional service organizations from achieving corporate tax status. One needs only compare section 301.7701-2(h) with sections 301.7701-2(a)-(g) to perceive this phenomenon. It at once becomes apparent that a dual set of criteria exists. One set is for the non-professional organization. The other and much stricter set of criteria is for the professional service organization. There is no support for this discrimination either in the cases or elsewhere. There is no factual or legal characteristic which would justify different tax treatment of closely held professional service organizations, on the one hand, and closely held non-professional service organizations on the other hand.[55]

Thus, the court seemed to strike down regulation (h) as it applies to either incorporated or unincorporated professional

48. 281 F. Supp. at 361.
49. OHIO REV. CODE ANN. § 1785.08 (Baldwin Supp. 1966).
50. 281 F. Supp. at 362.
51. *Id.*
52. 286 F. Supp. 839 (S.D. Fla. 1968).
53. FLA. STAT. ANN. § 621 (Supp. 1969).
54. 286 F. Supp. at 843.
55. *Id.* at 844.

groups. An unincorporated professional group, therefore, need only possess the more leniently defined corporate characteristics of regulations (a)-(g). The professional group in *Kurzner* would not have possessed a majority of corporate characteristics under regulation (h) since its shareholders were each liable for their own negligent acts. Further, the stock was transferable only to another licensed physician and only with the consent of the majority of the other stockholders. But the court pointed out that the liability of the shareholders was sharply limited to their own acts. This differs only slightly from the liability of a shareholder in any other corporation.[56] Also, the limitation on transferability did not affect the ". . . ability to transfer interests without disturbing the continuity of the enterprise and the ability to issue shares to large numbers of participants. . . . It is the latter factor and not the presence or absence of limitations on transferability per se that is important."[57] The court concluded that the above attributes were sufficient to satisfy the corporate criteria of regulations (a)-(g) and used this as the second grounds for granting corporate tax status to the medical group.

This second ground received further support in *Holder v. United States.*[58] That case involved a group of doctors organized under the Georgia Professional Associations Act.[59] *Holder* did not consider whether the organization was incorporated under Georgia law. It simply examined the attributes given that organization under Georgia law and concluded that those attributes satisfied the four basic criteria of corporate status. The court recognized that the stringent provisions of regulation (h) applied only to professional service organizations and that every other type of organization was to be judged by the more lenient criteria of regulations (a)-(g). *Holder* declared this stricter criteria for professional service organizations discriminatory and invalid.[60] Professional service organizations, like all other organizations, are to be measured against the definitions of limited lability, centralized management, transferability of interests, and continuity of life found in regulations (a)-(g).[61] The medical organization in *Holder* possessed all four of these characteristics and was granted corporate tax treatment.[62]

Thus, it seems that even an unincorporated professional service organization can be taxed as a corporation if it possesses a majority of the corporate characteristics as defined in regulations (a)-(g). Also, although the limitations placed on professional

56. *Id.* at 845.
57. *Id.*
58. 289 F. Supp. 160 (N.D. Ga. 1968).
59. GA. CODE ANN. §§ 84-4301-1-18 (Supp. 1966).
60. 289 F. Supp. at 165.
61. *Id.* at 166.
62. *Id.*

service organizations by many states would have precluded corporate status under regulation (h), those limitations will not prevent the organization from achieving corporate status under regulations (a)-(g). The above four district court cases[63] have apparently ended the long history of discrimination by the Internal Revenue Service against professional service organizations. Absent future congressional action, professional service organizations should now have the same opportunity to take advantage of the benefits of corporate income tax law as any other business organization.

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63. The validity of regulation (h) was also questioned in St. Louis Park Medical Center v. Lethert, 286 F. Supp. 271 (D. Minn. 1968), but the issue was not decided. The taxpayer requested a declaratory judgment, which the court lacked the power to grant, and, in the alternative, a preliminary injunction to prevent the assessment of the tax. Since there was no irreparable harm threatened, the injunction was also denied. The taxpayer was left to the remedy of an action for a refund. The same issue was also raised but not decided in Hill & Thomas Co. v. United States, 392 F.2d 204 (6th Cir. 1968). In that case the taxpayer's suit was dismissed as moot since the Commissioner tendered refund of the entire tax paid.