THE PROFESSIONAL CORPORATION CONTINUUM

In 1962, New Jersey first enacted the Professional Service Corporation Act.[1] Late in 1969, this Act was repealed and re-enacted in substantially the same form.[2] This revision corrected technical errors and clarified ambiguities. Specifically, the new statute contains provisions of particular tax significance. Under this legislation, shareholders clearly have limited liability.[3] Under both the original and current law, attorneys are permitted to incorporate, subject to the Court Rules. Simultaneous with the re-enactment of the Professional Service Corporation Act, the New Jersey Supreme Court promulgated R. 1:21-1A which permits attorneys to incorporate under this Act. The additional requirements of the Court Rule are that the corporation maintain specified amounts of professional liability insurance[4] and use the word "corporation" on corporate documents[5].

Most other states have created similar professional corporation laws.[6] The Internal Revenue Service, however, was not willing to accept these organizations as corporations for federal income tax purposes, due to the substantial tax savings from corporate status.

PROFESSIONALS AND CORPORATE BENEFITS

A professional person derives significant economic benefits by operating as an employee of his own professional service corporation. The most significant tax benefits are in the area of pension and deferred profit sharing deductions. Under the current Internal Revenue Code, a corporation may take as an expense deduction amounts contributed to employee pension and profit sharing plans.[7] The only limitation is that such deductible expenses may not exceed 10% of the employee's salary for profit sharing[8] and 15% of the employee's salary for pension contributions, but there are no dollar limitations.[9] The amounts deducted are not taxed to the individual in that year.[10] In

1 N.J. STAT. ANN. 14:19-1 (1962).

2 L. 1969 ch. 232, N.J. STAT. ANN. 14A:17-1 *et seq.* (N.J. Sess. L. Service No. 5, 1969).

3 L. 1969 ch. 232 (8), N.J. STAT. ANN. 14A: 17-8.

4 R. 1:21-1A(a)(3).

5 R. 1:21-1A(c).

6 1969-5 P-H #41,608. At the time of this writing all but four jurisdictions (Washington, D.C., Iowa, New York and Wyoming) have legislation or court rules in this area.

7 INT. REV. CODE OF 1954 § 404, 26 U.S.C. 404.

8 INT. REV. CODE OF 1954 § 404(a)(1)(c).

9 INT. REV. CODE OF 1954 § 404(a)(3).

10 INT. REV. CODE OF 1954 § 402.

qualified plan funds, yearly earnings of the investments are not annually taxed;[11] but final distribution payments to the employee are taxed.[12] For amounts contributed to the fund before 1970, the corporate employee may elect to take a lump sum distribution at capital gain rates. For contributions after 1969, the amount distributed which represents employer contributions is not eligible for capital gains treatment.[13]

Although the partner and sole proprietor may also set aside income for retirement under the so-called Keogh plans,[14] the deduction is limited to 10% of the individual's income or twenty-five hundred dollars, whichever is less.[15] This difference alone may justify incorporation.

In other areas corporate status confers significant tax benefits, including deductible corporate expenses not taxed to the individual.[16] The corporation may deduct the cost of medical expenses, reimbursement plans and wage continuation plans.[17] Also the corporation may deduct the cost of group term life insurance,[18] health and accident insurance[19] and pay up to five thousand dollars in death benefits,[20] which will not be included in the gross income of the beneficiary.

Before 1971, a corporation with ten or less shareholders could elect to be a subchapter "S" corporation,[21] in which case the shareholders did not forfeit the pension, profit sharing, and other tax benefits but had the corporation's taxable income attributed to them individually.[22] This provision enabled the corporation to avoid the personal holding company and accumulated earnings taxes. The 1969 Tax Reform Act effectively removes this possibility. Current law limits the pension and profit sharing deductions to amounts which are equal to the benefits available under the Keogh Plans.[23]

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11 INT. REV. CODE OF 1954 § 403, 501.

12 INT. REV. CODE OF 1954 § 402.

13 INT. REV. CODE OF 1954 § 402(a). This change was brought about in the Tax Reform Act of 1969 P.L. 91-172 § 515(d).

14 INT. REV. CODE OF 1954 § 404(e).

15 INT. REV. CODE OF 1954 § 404(e)(1).

16 Berrein Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX LAW REV. 1 (1967); *Professional Corporations and Associations*, 75 HARV. L. REV. 756 (1962).

17 INT. REV. CODE OF 1954 § 105.

18 INT. REV. CODE OF 1954 § 79.

19 INT. REV. CODE OF 1954 § 105(e).

20 INT. REV. CODE OF 1954 § 101(b).

21 INT. REV. CODE OF 1954 § 1371.

22 INT. REV. CODE OF 1954 § 1373; *Professional Corporations, supra* note 16.

23 INT. REV. CODE OF 1954 § 1379. This entire section was added by the Tax Reform Act of 1969 P.L. 91-172 § 511(d).

MODEL #1

	Keogh	Corp.	Keogh	Corp.	Keogh	Corp.	Keogh	Corp.
Earnings	50,000	50,000	35,000	35,000	25,000	25,000	15,000	15,000
Pension Allowable	2,500	7,500	2,500	5,250	2,500	3,750	1,500	2,250
	47,500	42,500	32,500	29,750	22,500	21,250	13,500	12,750
Profit Sharing		5,000		3,500		2,125		1,275
	47,500	37,500	32,500	26,250	22,500	19,125	13,500	11,475
Group Life Ins. $50,000		800		800		800		800
	47,500	36,700	32,500	25,450	22,500	18,325	13,500	10,675
Group Med. Ins.		200		200		200		200
Individual Gross Income (Taxable)	47,500	36,500	32,500	25,250	22,500	18,125	13,500	10,475
Std. Ded. 141	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
	46,500	35,500	31,500	24,250	21,500	17,125	12,500	9,475
Pers. Exmpt. 151	2,400	2,400	2,400	2,400	2,400	2,400	2,400	2,400
Taxable Income	44,100	33,100	29,100	21,850	19,100	14,725	10,100	7,075
Income Tax	14,110	9,122	7,529	4,772	4,128	2,916	1,842	1,204
Net after Tax	29,990	23,978	21,571	17,078	14,972	11,809	8,258	5,871
After tax cost of equal coverage to Keogh man	11,000		7,250		4,375		3,025	
Net Disposable Income	18,990	23,978	14,321	17,078	10,597	11,809	5,233	5,871
Loss	—	18,990	—	14,321	—	10,597	—	5,233
Savings to Incorporated Professional	—	4,988	—	2,750	—	1,212	—	638

The above chart illustrates the savings available by use of the professional service corporation. It compares the non-corporate individual with the corporate employee stockholder.[24] Line 1 is a range of earnings after non-tax expense deductions. The left column of each income level is a scale for the sole proprietor or partner. The right column represents that of the corporate employee. Lines 2 and 3 show the maximum deductions before tax for pension and profit funds. Lines 4 and 5 represent before tax expense deductions allowed to the corporation which are not deductible by partners and individuals. Line 6 shows the before tax gross income after these deductions have been taken. Lines 7 and 8 are basic deductions to reach taxable income (Line 9). Line 10 is the amount of tax liability. The corporate employee has both a lower tax liabiltiy and a greater pension and profit sharing fund at all income levels. Line 11 shows the amount the taxpayer receives after taxes. Line 12 is the amount the non-corporate person must spend from his after tax income to give him the same pension fund, profit sharing fund, and insurance coverage. After he spends this amount, line 13 shows what he has left as compared with the corporate employee. Line 15 is the corporate employee's saving.

DISADVANTAGES OF CORPORATE STATUS

There are certain disadvantages to operating as a corporation. Problems of stock valuation may arise at death. Management and financial control may be more stringent than that required by other forms of business organization. Although this may be an additional burden to some professionals, generally it will be to their benefit.

The more significant disadvantages of corporate status include severe tax penalties, the "accumulated earnings"[25] tax and the "personal holding company" tax.[26] Both taxes may be avoided by proper tax planning.

The personal holding company tax has become a popular consideration but should not be a major impediment. A seventy percent tax is imposed upon "undistributed personal holding company income." If fifty percent of the stock of a corporation is owned by less than five individuals and sixty percent of the corporation's income is personal holding company income, the corporation will be a personal holding company.[27] Professional service corporations meet this income requirement since personal holding company income is income derived from personal service contracts. But income received by the corporation will not be such income if it is attributable to a person who owns less than twenty-five percent of the capital stock of the corporation.[28] The seventy percent tax is imposed upon the undistributed personal holding company income, which is generally equivalent to the taxable income of the corporation.[29] Hence, to avoid the personal holding company status, the corporation must have a sufficient number of shareholders to avoid the stock ownership requirements or to insure that no shareholder owns more than twenty-four percent of the stock of the corpo-

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24 In model one the following assumptions are made:

(a) In every instance all benefits already exist for the employees of the self-employed individual;

(b) The dollar figures used are the amount which in the case of a self-employed person would be his net earnings from self-employment;

(c) The owner or executive wishes to make the maximum and future-protection contributions;

(d) The taxpayer is married, and has four personal exemption deductions. He elects to take the standard deduction pursuant to Int. Rev. Code of 1954 #141. Physicians Management, March 1969 presents many useful models.

25 INT. REV. CODE OF 1954 § 531.

26 INT. REV. CODE OF 1954 § 541.

27 INT. REV. CODE OF 1954 § 542(a).

28 INT. REV. CODE OF 1954 § 543(a)(7).

29 INT. REV. CODE OF 1954 § 545. The taxable income is subject to certain adjustments not considered here.

ration, thereby avoiding the income requirement. Alternatively, in a smaller organization the personal holding company status can be simply accepted. The onerous tax can be avoided by carefully programming salaries and distributions to result in a zero undistributed personal holding company income. Although the professional cannot accumulate funds in the corporation, he still gains the other significant tax benefits.

Shareholders in high income brackets seek to have their corporations retain profits until such time as their income from other sources is lower. If the retained profits are not needed in the business for growth or current operations, the funds might be invested by the corporation. To prevent such tax avoidance there is an accumulated earnings tax.[30] The rate of tax is 27½% on the first $100,000 of improperly accumulated taxable income and 38½% on improperly accumulated taxable income over $100,000. There are two reasons why this tax is not a severe obstacle to professional corporations. A credit of $100,000 is allowed before computing an improper accumulation.[31] Secondly, professional shareholder-employees will wish to pay out most of the gross corporate income to themselves as salaries.

Despite the desirability of these tax advantages, the professional corporations have had great difficulty in attaining them. In order to understand the problem, one must first view the professional associations in their historical perspective.

THE PROFESSIONAL ASSOCIATION PROBLEM

The current definitions of economic entities for federal income tax classification are:

(A) (1) Person—The term person shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(A) (2) Partnership and Partner—The term partnership includes a syndicate, group, pool, joint venture, *or other unincorporated* organization, through or by means of which any business, financial operation, or venture is carried on, and which *is not* within the meaning of this title, a trust or estate or a *corporation;* and the term partner includes a member in such syndicate, group, pool, joint venture or organization.[32] (Emphasis added.)

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30 INT. REV. CODE OF 1954 § 531.

31 INT. REV. CODE OF 1954 § 535(c).

32 INT. REV. CODE OF 1954 § 7701(a). These definitions have a significant legislative history. The definitions of person and corporation are substantially the same as provided

> (A) (3) The term "corporation" includes associations, joint stock companies, and insurance companies.

By this statute, unincorporated associations are taxable as corporations.

A significant anachronism existed in the Revenue Act of 1918 in the following definition:[33]

> The term personal service corporation means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital whether invested or borrowed is not a material income producing factor.

Such corporations had their income taxed as partnerships.[34] Both the definitions and the tax provision were shortly thereafter extinguished. The Revenue Act of 1921 contained those provisions, but it specifically called for their expiration on December 31, 1921.[35] Although the reason these provisions were repealed is obscure,[36] since their lapse, no subsequent revenue act required professional service corporations to be treated differently than other types of corporations.

When Congress repeals a revenue act without reinstatement in a similar form, the act and any implications or regulations derived from it are by necessity repealed. Additionally, if Congress is aware of a situation and takes no affirmative action, the problem should be treated as having been considered and subject only to the confines of existing law. The application of these two principles to the legislative history of professional service corporations supports a conclusion that profes-

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in the Revenue Act of 1918. (Revenue Act of 1918, c. 18, 40 Stat. 1057, 1058). Under this Act partnerships were not defined but were classified and taxed as individuals. The partnership definition first appeared in the Revenue Act of 1932 and was substantially the same as the current definition. (Revenue Act of 1932, c. 209, 47 Stat. 169, 289, § 1111). This addition of the partnership classification did not create a new taxable entity. Today partnerships and individuals are still taxed the same, and only corporations, associations, and trusts are separate taxable entities.

33 Revenue Act of 1918, c. 18, 40 Stat. 1057, 1059, § 200.

34 Revenue Act of 1918, c. 18, 40 Stat. 1057, 1070 § 218(e)

35 Revenue Act of 1921, c. 136, 42 Stat. 227, 245 § 218(d).

36 Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 617 n.66 (1965). (Hereafter Scallen). Professor Scallen presents a comprehensive analysis of this statute including interesting excerpts from the committee reports. He states: The appearance for a short time of the personal service corporation is significant since Congress thus recognized the existence of presumably a substantial number of personal service businesses, conducted under the form of a corporation. Apparently it was thought that these businesses should be treated the same as partnerships for one reason or another. Certainly no doubt remains, if history is any guide, that there can be, for federal income tax purposes, personal service corporations treated as corporations. *Id.* at 618.

sionals may incorporate and the professional service corporations should be treated as all other corporations.

The historical development of the professional corporations' and professional associations' tax status closely follows that of the Internal Revenue Code. From its inception until 1939, the revenue act did not impose a highly progressive tax upon the individual's income. Since 1939, individual's income has become subject to an increasingly progressive tax rate. Prior to this time the more onerous tax consequences had attached to corporate and association status.

Contemporaneous with the changing tax laws, the United States Supreme Court handed down *Morrissey v. Commissioner* which considered[37] whether a business trust should be taxed as an association (which meant corporate treatment) or as a trust. This case established the basic rule that a trust should be taxed as an association if it resembled a corporation. The Court considered a number of factors important in determining whether an unincorporated trust should be treated as a trust or association; among these were the ability of the organization to hold title to property, and the qualities of centralized management, continuity of life, transferability of interests, and limited liability.

In the following year, the Treasury Department made its first attack upon professionals. The medical group in *Pelton v. Commissioner of Internal Revenue*[38] operated a medical clinic under a trust agreement. The government argued that the trust should be treated as an association, while the doctors argued that they should be subject only to the personal income tax. The Circuit Court of Appeals held the clinic was taxable as an association on the ground that the trust carried on a business enterprise for profit, and it had a substantial resemblance to a corporation under the *Morrissey* test.

The *Pelton* group did not and could not possess the *Morrissey* factor of limited liability under state law. However, the fact was held to be insignificant since an association, which is the entity taxed as a corporation, is not required to have limited liability. Furthermore the regulations specifically provided for such groups to be treated as associations "even though under state law such organizations were technically partnerships."[39]

The tax status of a professional group was questioned again in *United States v. Kintner*[40] in which the taxpayer actively sought the

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[37] 296 U.S. 344 (1935).
[38] 82 F.2d 473 (7th Cir. 1936).
[39] *Id.* at 476.
[40] 216 F.2d 418 (9th Cir. 1954).

corporate mantle to gain the significant tax advantages made available by tax law of 1942.[41] *Kintner* involved a medical group of twenty-four doctors (in total thirty-eight employees) who had revised their business structure from partnership to association by an agreement which followed the format of a corporate charter. The court applied the *Morrissey* factors and found the medical group most resembled a corporation and was, therefore, taxable as an association. The government first contended that "the practice of medicine is personal, and that a corporation cannot engage in such practice."[42] The court rejected this argument. Subsequently, the Treasury Department announced it would not accept or follow the Kintner decision.[43] Significantly, the Treasury did not petition for certiorari.

This rationale was followed in *Galt v. United States.*[44] In that case, a group of doctors was not allowed to incorporate under state law. Nevertheless the court held the association was entitled to corporate tax treatment; the unavailability of a state corporate charter was unimportant. Again the Treasury did not appeal the case.

In response to *Galt* and *Kintner*, in 1960, the Treasury "promulgated, under the Internal Revenue Code of 1954, Treasury Regulations 301.7701-2-(a)(1), (2), and (3), with the purpose of indirectly overturning the decisions in Kintner and Galt."[45] Indeed, this purpose was so obvious that the regulations came to be generally known as the "Kintner Regulations."[46]

THE KINTNER REGULATIONS

The 1960 Kintner Regulations establish rules making it extremely difficult for any unincorporated organization to achieve association status.[47] There were no regulations interpreting the term corporation

41 INT. REV. CODE OF 1939 § 165(a) as amended 1942; United States v. Kintner, 216 F.2d 418, 426 (9th Cir. 1954).

42 216 F.2d at 421.

43 Rev. Rul. 56-23, 1956-1 CUM. BULL. 598.

44 175 F. Supp. 360 (N.D. Tex. 1959).

45 United States v. Empey, 406 F.2d 157 (10th Cir. 1969).

46 *Id.*

47 Scallen, *supra* note 36, at 653. This authority has dubbed these sections the Anti-Kintner Regulations. He presents a comprehensive study of the Treasury regulations construing the "association" status from their origin to the 1960 Kintner Regulations. He reaches the compelling conclusion that the Kintner regulations were without precedent and a complete reversal of the law as established by the Treasury regulations over the prior forty years. For an argument supporting the regulations see Bittker, *Professional Associations and Federal Income Taxation*, 17 TAX LAW REV. 1 (1961) and by the same author, *Professional Service Organizations: A Critique of the Literature*, 23 TAX LAW REV. 429 (1967). Professor Bittker supports the Kintner Regulations on the grounds of logic and the necessity of adhering to theoretical postulates.

as used in Section 7701(a)(3) of the Internal Revenue Code until 1965, when the Treasury added Regulation 301.7701-2(h). This section, concerning the classification of professional service organizations, has been since held invalid and will be considered later in this article.

Section 1(c) of the Kintner Regulations defines the effect of local law.[48] The tax class into which an organization falls is to be determined under the Internal Revenue Code in order to avoid tax variations among similar organizations resulting from state law classifications. For example, it would seem that, although a general partnership will not be taxed as an association merely because it is so designated by local law, it might be treated as an association for tax purposes if granted certain features under state law.

Treasury Regulation 301.7701-2 sets out the features an organization must have to be taxed as an association. These are: (i) associates; (ii) a business profit motive; (iii) continuity of life; (iv) centralized management; (v) limited liability; (vi) free transferability of interest. Obviously, the Kintner Regulations are an enlarged codification of the Morrissey factors. In order for an organization to be treated as an association it must more resemble a corporation than a partnership or trust. Characteristics common to both a corporation and a trust or partnership are disregarded,[49] and remaining attributes of the organization must more resemble corporate characteristics. Continuity of life,[50] centralized management, free transferability of interest, are prime considerations. An organization must have a preponderance of these features to achieve association status.

Nevertheless, an unincorporated two man medical group won association status, in *Foreman v. United States*.[51] The government argued that, "since physicians cannot legally form a corporation for the practice of medicine under state law, that, therefore, regardless of whatever other tests the association might meet, the association could never have

[48] Treas. Reg. 301.7701-(1)(c) (1960) which provides: Although it is the Internal Revenue Code rather than local law which established the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationship of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.

[49] Treas. Reg. 301. 7701-2(a)(3) (1960).

[50] Treas. Reg. 301.7701-2(b) (1960) states:

An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization (2) . . . dissolution means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined *under local law* . . . . (Emphasis added.)

[51] 232 F. Supp. 134 (S.D. Fla. 1964).

the requisite substantial resemblance to a corporation required under the federal statute."[52] This argument was summarily dismissed because an association was to be determined under the federal criteria. The government next contended that income earned by professionals was not the normal type of corporate income, and, therefore, the association should not be treated as a corporation. The District Court made the following decision on the point:

> The fallacy of this argument is readily apparent when one considers the large number of corporations presently existing in our economy whose primary income is earned solely from the personal services of their employees. The corporate tax status of businesses engaged in advertising or promotion, investigation, sales, contract janitorial or secretarial service, to name a few has not been seriously questioned to the court's knowledge.[53]

In *Foreman* limited liability was not present, and the features of centralized management, continuity of life, and free transferability of interests were only theoretically present. In the balance, a majority of the Kintner Regulation requirements were met. In the historical development of the professional corporation controversy this case is the last noteworthy decision involving the Kintner Regulations.[54]

THE 1965 REGULATIONS

Although as a general rule corporations are separate taxable entities, a number of pervasive tax law doctrines of judicial origin may require the incidence of taxation to fall upon the involved individuals. In *Commissioner v. Court Holding Company*, the Supreme Court held that "the incidence of taxation depends upon the substance of a transaction."[55] Tax avoidance may not be achieved by use of a corporation which has no business purpose for its existence.[56] When a taxpayer conducts a transaction for tax purposes in a number of individual transactions which lack a business purpose, the *step transaction* doctrine permits the government to collapse the formal steps and to impose taxation upon the end result as if the simplest route had been taken.[57] Generally in the case of the continuously existing corporation, except

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52 *Id.* at 136.

53 *Id.* at 137.

54 A recent case involving a business trust association is Ahola v. United States, 300 F. Supp. 1055 (D. Minn. 1969).

55 324 U.S. 331 (1945).

56 Gregory v. Helvering, 293 U.S. 465 (1935).

57 SURREY AND WARREN, FEDERAL INCOME TAXATION 1341 (1960 ed. with 1961 supp.).

in instances where the corporation is in fact a "sham" or without business purpose, the corporate entity cannot be disregarded and its income taxed to the shareholders.[58]

Since the 1960 regulations were aimed at unincorporated groups, shortly after their adoption significant developments occurred. Many states enacted statutes providing for either the incorporation or association of professional people. In 1965, the Treasury Department attempted another *coup d'etat* with the promulgation of Treasury Regulation 301.7701(2)(h) and the amendment of Treasury Regulation 301.7701-1(c). These changes were the Treasury's response to the state incorporation statutes.[59] Its purpose was:

> an administrative explanation of why professional men cannot, absent a much more severe departure from the norms of professional regulation enforced by the states and the traditional mode of organization and operation permitted professional men joined together in a mutual enterprise, achieve the status of corporations or associations under the Federal taxing statute.[60]

With the 1965 amendments, the Treasury Department sought to achieve a major change in tax law. These Regulations specifically provided that a validly chartered and bona fide corporation would not necessarily be treated as a corporation for tax purposes.[61] Prior to this time, such a corporation had never been denied corporate tax status. The effect of subsection 2(h) was to make it practically impossible for a professional corporation to achieve corporate tax status. If an employment relationship was required for ownership or participation,[62] if upon removal the member had to transfer his stock to another,[63] or if a sale of stock could be made only after approval of the other shareholders,[64] the corporation then could not achieve continuity of life or free transferability of interest. Nine specific areas of decision are required to be vested in a management group for centralization of management; moreover, it is impossible for the organization to have centralization of management where the professional employee retains

58 Moline Properties Inc. v. Commissioner, 319 U.S. 436 (1943); National Investor's Corp. v. Hoey. 144 F.2d 466 (2d Cir. 1944).

59 Empey v. U.S., 272 F. Supp. 851 (D. Colo. 1967). The Treasury admitted in its brief in this case that these regulations were made: "In response to an outpouring of state legislation authorizing the formation of professional service associations aimed at providing professional men, such as lawyers or doctors, with the means of achieving corporate or association status for federal tax purposes." *Id.* at 852.

60 *Id.*

61 Treas. Reg. 301.7701-1(c) (1965).

62 Treas. Reg. 301.7701-2(h) (1965).

63 Treas. Reg. 301.7701-2(h)(2) (1965).

64 Treas. Reg. 301.7701-2(h)(5) (1965).

traditional professional responsibility.[65] Limited liability requires a member to be subject to no greater liability than shareholders of an ordinary business corporation. If a mutual agency relationship exists, there is no limited liability. There is no free transferability of interest if the right to share in the profits is contingent upon an employment relationship, and other members have a right of first refusal.[66]

These regulations are obviously an assertion that the Treasury has the authority to refuse to accept the corporate status of an entity granted corporate status under state law and to require such an entity to meet the stringent tests established at this time. Prior to this promulgation, the Treasury never refused such status to a corporation which had a business purpose.[67] The Treasury does not have such broad authority. Statutory intent seems to require revenue classification of entities as corporations if they are so labeled under state law.[68] It is true that the federal government does not have to accept a state law corporation when the entity is in no way a bona fide corporation. However, when a bona fide corporation exists, such recognition is demanded. A distillation of the cases indicates that for tax law purposes there are only three real factors incident to the recognition of a corporation: limited liability, perpetual existence, and the ability to hold title. All three factors can exist even in a one-man corporation. Limited liability will exist if under state law a shareholder employee is not liable for the debts merely because he is a shareholder. Although he might be liable for torts he committed as an employee, so long as his liability for corporate contract debts is limited to the corporate assets, limited liability will exist. Continuity of life or perpetual existence must be determined under state law. Similarly questions of title are

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65 Treas. Reg. 301.7701-2(h)(3) (1965).

66 Treas. Reg. 301.7701-5(ii) (1965).

67 Bittker, *supra* note 47, at 26; Eaton, *supra* note 16. This article contains a cogent argument that state labels (corporation) are effective to confer corporate tax status, and the Treasury is without authority to refuse such status. At page 34 the authority says "even a one man incorporated talent such as a cartoonist or actor is recognized as having corporate status. When Congress in 1937 decided to curtail the tax advantages of incorporating talent it did not redefine these entities as noncorporate, but merely surtaxed them in certain instances as personal holding companies."

68 Scallen, *supra* note 36, at 622, makes two pertinent observations.

> Taking the plain meaning of the statute and whatever legislative history can be found, the conclusion can be reached that local law characterization was actually intended. [And at 653] First, the statutory language refers to corporation in a way that makes one think Congress merely intended to have us look to whether a state had issued a charter labelled corporation to the organization. Second, the legislative history reinforces the view that businesses having a corporate charter were to be classified as corporations, and that the classification problem related to businesses without corporate charters.

purely within the realm of local law. If under state law, the corporation continues to hold title after the death of the stockholder, perpetual existence is provided.[69]

JUDICIAL RESPONSE TO THE 1965 REGULATIONS

The 1965 regulations have been held invalid on various grounds in fourteen cases to date.[70] With the 1965 amendments invalid, it seems a necessary consequence that all bona fide professional corporations be automatically granted corporate tax treatment. Although the Treasury Department has also argued that the Kintner Regulations are applicable to professional service corporations, the invalidating cases establish a strong basis for the acceptance of all bona fide professional corporations into the corporate tax status.

In *Holder v. United States*,[71] the government sought to tax an eleven-man medical clinic organized under the Georgia Professional Association Act as a partnership. The court, however, found that the organization met the test of *Morrissey* and the Kintner Regulations and, more significantly, that the 2(h) professional service organization regulations were invalid. "The principal purpose in forming the association was the business purpose of controlling a sizable and unwieldy organization and to obtain other benefits, such as limited liability."[72] Since section 2(h) was contrary to the settled construction of the revenue statute, it was held invalid.

> Moreover, new paragraph (h) of the regulations is contrary to a legislative intention evidenced by the statutory definitions which have remained unchanged for thirty-five years, in the case of the Codes' definition of the term "partnership" and for forty-nine years, in the case of the Code's definition of the term corporation. A regulation which would contradict a statute is invalid.[73]

69 Comment, 24 TAX LAW REV. 291-299 (1969).

70 Empey v. U.S., 272 F. Supp. 851 (D. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1969); Holder v. U.S., 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd*, 412 F.2d 1189 (5th Cir. 1969); Kurzner v. U.S., 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969); O'Neill v. U.S., 281 F. Supp. 359 (N.D. Ohio, 1968); *aff'd*, 410 F.2d 888 (6th Cir. 1969); Ahola v. U.S., 300 F. Supp. 1055 (D. Minn. 1969); Cochran v. U.S., 299 F. Supp. 1113 (D. Ariz. 1969); First Nat'l Bank, etc. v. U.S., — F. Supp. —, 23 AFTR.2d 69-603 (N.D. Okla. 1969); Kelsey v. U.S., — F. Supp. —, 24 AFTR.2d 69-5468 (W.D. Ark. 1969); Mendelsohn v. U.S., — F. Supp. —, 24 AFTR.2d 69-5471 (W.D. Ark. 1969); Ryan v. U.S. — F. Supp. —, 24 AFTR.2d 69-5943 (D. Minn. 1969); Smith v. U.S., 301 F. Supp 1016 (S.D. Fla. 1969); Van Epps v. U.S., 301 F. Supp. 256 (D. Ariz. 1969); Williams v. U.S., 300 F. Supp. 928 (D. Minn. 1969); Wallace v. U.S., 294 F. Supp. 1225 (E.D. Ark. 1968).

71 289 F. Supp. 160 (N.D. Ga. 1968).

72 *Id.* at 164.

73 *Id.* at 165.

Wallace v. United States[74] gives an additional judicial response to one argument. In *O'Neill v. United States*,[75] the taxpayer had argued that Congress sought to control abuse of the corporate status by regulatory statutes such as the reasonable salary limitation, the collapsible corporation provision, the personal holding company tax, and the accumulated earnings tax. Further, Section 7701 was "not intended as a regulatory provision but serves only a broad definitional or taxonomical function."[76] The Court in *Wallace* took notice that the purpose of professional corporation statutes was to afford professionals the opportunity to operate under the corporate form "so as to gain the tax benefits."[77] Further, this court apparently accepted the *O'Neill* argument and found the purpose of professional corporation statutes valid. The District Court in expressing this attitude said:

> It may well be argued that the state legislation which has been described opens an undesirable loophole through which professional people can slip and thereby avoid paying their fair share of the national tax burden. If so, that loophole may be closed by the Congress by appropriate legislation.[78]

THE APPELLATE DECISIONS

The first appellate decision adjudicating the tax status of a professional service corporation was *Empey v. United States*.[79] The Drexler and Wald Professional Company (hereafter DWPC) was originally a four-man law partnership which incorporated under the Colorado Corporation Code[80] and Rule 265 of the Colorado Rules of Civil Procedure. A member's liability was limited to corporate assets so long as the corporation maintained malpractice insurances. Although the employment contracts gave the directors substantial control over the employees' work, in routine cases the individual lawyer conducted the matter and determined the fee without consulting the directors. The corporation had a perpetual charter under state law. Shares were transferable only to other licensed lawyers and the corporation had a right of first refusal at the price proposed to be paid by an outside transferee. At retirement or death the shareholder or his estate had the option to

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74 294 F. Supp. 1225 (E.D. Ark. 1968).

75 281 F. Supp. 359, 363 (N.D. Ohio 1968).

76 *Id.*

77 Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1969).

78 *Id.* at 1230.

79 406 F.2d 157 (10th Cir. 1969). The last appellate decision, Holder v. United States, 412 F.2d 1189 (5th Cir. 1969) affirmed per curiam.

80 Colo. Corp. Code, 2 COLO. REV. STAT. ANN. § 1-10 (1963).

have the corporation redeem the shares at book value. Bank loans and rent contracts were executed in the corporate name without any personal guarantee. Certain officers had the exclusive authority to contract corporate debts.

The District Court took cognizance of the tax purpose of professional corporation statutes and gave the opinion that the purpose of the 1965 Treasury Regulation amendments was to prevent professionals from achieving corporate tax treatment. The court held that the validly incorporated and operating professional corporation could not be treated as a partnership for tax purposes. Since the Sec. 7701(A)(2) definition of the term limited itself to unincorporated organizations, treatment of DWPC as a partenrship would be plainly inconsistent with the statute. In response to the Treasury's desire, the opinion states:

> The defendant has cited no cases and we have found none which has construed the term "partnership" to include an "incorporated" organization, nor had the defendant referred to any legislative history which would indicate a Congressional intent to do so. . . . The Court concludes that the Treasury Regulations are inconsistent with the statute and the Judicial construction thereof and that the Regulations constitute the exercise of a non-delegable legislative function and are invalid and unenforceable.[81]

In order to make a complete disposition of the arguments presented, the court assumed the regulations valid and found that DWPC more resembled a corporation than a partnership.

The Court of Appeals postulated the issue of the case to be "whether the corporation should be classified for federal income tax purposes as a corporation or partnership."[82] The decision encompasses both the amended Kintner Regulations and the added professional service organization regulations. The court specifically pointed out that the regulations under consideration were all of the amendments wherein the Treasury asserted its authority to refuse recognition to a corporation which was valid under local law.[83] One could be led to believe that only the professional service organization regulations (2)(h) were being held invalid. This erroneous conclusion would lead to the incorrect deduction that the amendment to section 301.7701-

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81 Empey v. United States, 272 F. Supp. 851, 853 (D. Colo. 1967).

82 United States v. Empey, 406 F.2d 157 (10th Cir. 1969).

83 *Id.* at 163. The court states, "The pertinent parts of an amendment to 301.7701-2 . . . applicable to professional service organizations: taxable years, beginning after December 31, 1964 (301-7701-(2)(a)(5) are set forth in Note 10." Note 10 included 301-7701-1(c) on the Effect of Local Law.

1(c), wherein the Treasury first asserts that it may deny recognition to a corporation valid under local law, was not being held invalid.[84]

The *Empey* appellate decision holds the amending regulations invalid and also that any professional corporation valid under local law, and not a sham, must be afforded corporate status for federal income taxes. Inherent in the rationale of the case is the conclusion that the Kintner Regulations dealt only with unincorporated associations and did not intend to establish criteria for testing validity of corporations. Examination of legislative history brought this judicial determination:

> Since 1921, Congress has not seen fit to provide different tax treatment for personal service corporations and other corporations, and it was not until 1965 that the Treasury attempted . . . such distinction.[85]

After explaining that the statutory definition of corporation extended the class beyond those entities ordinarily corporate, the court said:

> Prior to 1965, the Treasury Department consistently treated an entity chartered and operated in good faith as a corporation under state law, as a corporation for Federal income tax purposes.[86]

In the first six months of 1969, two other decisions by Courts of Appeals dealt mortal blows to the Treasury Department's position. *United States v. Kurzner*[87] and *United States v. O'Neill*[88] resulted in taxpayer victories. *Kurzner* decided that when a state charter provides a corporation with the opportunity to enjoy the *Morrissey* factors it must be accorded corporate tax status. Ownership of property by a separate legal entity "is inherently a matter of state law. Insofar as an entity is empowered by the local legislature to hold title to property of the enterprise, the entity will possess at least one corporate attribute."[89] Similarly, continuity of life is purely a question of local law. *Morrissey* did not require centralized management but only the opportunity to allow for centralized management. With respect to the

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84 *Id.* at 169. With respect to the Kintner Regulations the court said, "However, they are apparently directed only at unincorporated organizations." And again, two paragraphs later, "However, the 1960 Regulations, unlike the 1965 amendment thereto, contain no indication of a change in the long followed administrative practice of treating a corporation organized and chartered under state law as a corporation for federal income tax purposes. That was a practice that had been tacitly approved by the Congress by its reenactment at least eleven times, of the definition of the term 'corporation' in substantially identical language." *Id.*

85 *Id.* at 165.

86 *Id.*

87 413 F.2d 97 (5th Cir. 1969).

88 410 F.2d 888 (6th Cir. 1969).

89 United States v. Kurzner, 413 F.2d 97, 103 (5th Cir. 1969).

fourth factor of facilitating "the transfer of beneficial interests without affecting the continuity of the enterprise," the court in *Kurzner* places the emphasis on "facilitate."[90] If the corporate form allows transfer of ownership without requiring dissolution, the feature exists; such transfers do not have to be in fact easy. Finally the criteria of limited liability does not require that an active participant be able to claim the same protection as a mere investor.[91] Apparently, the government argued that a corporation must be a 'pure' corporation. The court's reaction to this theory was:

> It would appear to us far preferable to adopt the Supreme Court's approach in *Morrissey*, vis, positing as corporate attributes only those characteristics which all corporations possess. . . . The approach of Professor Bittker and the IRS holds that some traditionally recognized corporations do not rise to the dignity of "pure" corporations because they do not measure up to the attributes of the ideal form. In our view this approach is supported by neither logic nor law.[92]

In sharp contrast to this viewpoint is the decision of *O'Neill v. United States* wherein the court states:

> The Morrissey case did deal with the definition of "corporation" under the statute, and we hold that it in no way supports the position of the Government that a corporation under state law must meet a test of resemblance to some federal standard of corporateness before it will be taxed as a corporation under federal law.[93]

In *O'Neil* the government refused to acknowledge the corporate status of a medical group organized under the Ohio Professional Association Act. The only difference between this corporation and other Ohio corporations was that only licensed physicians could be shareholders. The District Court construed the liability provision of the statute to grant limited liability.[94] Although the court held Treasury Regulations 301.7701-2(h) invalid as unreasonably discriminatory and an instance of administrative overreaching, the corporation was held to be a corporation within the confines of Treasury Regulations 301.7701-2 (a-f), the Kintner Regulations. The Court of Appeals went much further by declaring both the Kintner Regulation and the Professional Service Organization Regulations to be invalid to the extent that they required a corporation, valid under state law, to be treated in any

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90 *Id.* at 103.
91 *Id.*
92 *Id.* at 110, n.58.
93 410 F.2d 888, 891 (6th Cir. 1969).
94 O'Neill v. U.S., 281 F. Supp. 359 (N.D. Ohio 1968).

other manner than as a corporation for federal tax purposes. The statutory foundation and legislative history of the tax statutes illustrate Congressional intent to treat all valid corporations as corporations in determining tax status.[95]

The government unsuccessfully advanced two other arguments. Although there was the difference of ownership requirement between the professional corporation and other business corporations, limitations on purpose and various other minor restrictions were historically incident to corporate status. Secondly, the court rejected the theory that it was merely accepting a state label. "The inquiry is whether the state granted existence to a corporate entity under the law. The fact that it limits the corporate properties to 'such as are supposed best calculated to effect the object for which it was created' has no bearing under the Internal Revenue Code."[96]

RECENT DEVELOPMENTS

On August 8, 1969, the government issued Technical Information Release 1019. In this announcement, the government conceded that "organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes." Secondly, the government stated it had decided not to apply for certiorari in *O'Neill* and *Kurzner.* This publication created the impression that the government completely capitulated in its attacks on profesional service corporations. A recent report states: "This development ended the confrontation with IRS, so that greater use can now be made of [the New Jersey Profesisonal Corporation Act]."[97] The government's acceptance of professional corporations in TR 1019 was subject to the following reservation: "Obviously, however, the government must reserve the right to conclude differently in any case that reflects special circumstances not present in *O'Neill* and *Kurzner.*"

The meaning of this caveat is now clear. The use of a professional service corporation may violate the tax doctrine of *assignment of income.* In *Lucas v. Earl,*[98] an attorney made a valid contract whereby

95 O'Neill v. United States, 410 F.2d 888, 897 (6th Cir. 1969).

96 *Id.* at 898.

97 REPORT OF SUPREME COURT SPECIAL COMMITTEE ON INCORPORATION OF ATTORNEYS, 92 N.J.L.J. 737, 742 (Nov. 13, 1969); *See also* Arthur L. Nims, *Professional Service Corporations in N.J.*, 92 N.J.L.J. 673 (1969).

98 281 U.S. 111 (1930).

99 *Id.*

his future earnings were attributable to himself and his wife jointly. He argued that he could be taxed on only one-half of this income, since the other half belonged to his wife. The court held that the revenue statutes taxed wages "to those who earned them."[99] "[N]o distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."[100] In *Helvering v. Horst*,[101] the donor of matured bond coupons who retained the bonds was held taxable on the income of the coupons rather than the donee. In *Helvering v. Eubank*[102] an insurance agent made an assignment of commissions to become payable to him for services he had rendered. The payments were held taxable to the assignor rather than the assignee. Since these early cases, the doctrine of assignment of income has had a continuing vitality, being applied in many areas including trusts, oil lease bonus payments, oil production payments, and rent cancellation payments.[103]

The doctrine sometimes comes up unexpectedly. Corporations are normally formed by the exchange of property for stock. Under Section 351 of the Code,[104] no gain is recognized to the transferor on the exchange. Nevertheless the transferors of accrued wages and inventory assets have been taxed on the realized income rather than the corporation.[105]

In *Jerome J. Roubik*,[106] the government won its first victory against professionals. In 1961, four radiologists formed a nominally capitalized professional corporation. Prior to this time, three of the doctors had been part-time employees of the fourth. Each shareholder-employee entered into an employment contract which formally gave the corporation the right to make work assignments, except where the employee held a full-time position in an institution. The doctors all maintained independent offices on which they had personal leases. Office purchases were made under personal contracts. The equipment in each office was owned by the physicians, and depreciation was taken

100 *Id.*

101 311 U.S. 112 (1940).

102 311 U.S. 122 (1940).

103 Lyon and Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case*, 17 TAX. L. REV. 393 (1962).

104 INT. REV. CODE OF 1954 § 351.

105 BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 113 (1966); Baldwin, *Section 351 of the Internal Revenue Code* and *Mid-Stream Incorporations*, 38 U. CINC. L. REV. 96 (1969); this article contains useful analysis of the problems of incorporation. Careful tax planning is required in this area particularly for professions; they may wind up with a significant amount of receivables taxed to them without the offsetting liabilities.

106 53 T.C. No. 36 (Dec. 3, 1969).

by them personally. They were generally under personal employment contracts with various hospitals. Although in some cases they took receipts in the corporate name, billing was under their individual names. Their receipts were deposited in the corporate bank accounts, and they were reimbursed for their expenses or the corporation directly paid the expenses. The court considered whether the corporation or the individuals apart from the corporation were carrying on the business. The corporate guise was disregarded in a two step analysis. First, the relationship among the employee-shareholders was purely formal and without substance; secondly the use of the corporation as a clearing account with separate bookkeeping had no purpose other than tax avoidance. The doctors actually earned the income, and attempted to attribute it to the corporation. Here the corporate form had no business purpose except the avoidance of individual taxation. A bona fide employee-corporation relationship did not exist. This distinguishes *Roubik* from other recent cases dealing with the professional corporation.

CONCLUSION

The New Jersey Professional Corporation Act enables properly planned and operated professional corporations to be treated as separate taxable entities. Factors which give substance to the corporate form, as determined by case law, require special attention. Failure to plan adequately may result in the application of the doctrine of assignment of income. Since a controversy as to corporate status will normally involve cumulative annual deficiencies, the cost of error will be great. Generally, applications of the assignment of income concepts have a tendency to grow in any given area rather than to remain static. Although the tax benefits more than justify use of the professional corporation, the tax laws of the United States are subject to the demands of a dynamic society. Any prediction regarding the permanency of a tax benefit is at best speculative.

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