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Michael S. Foreman

James B. Bogner

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to its full reach, an increasing willingness to intervene in prison operations indicates they are moving in that direction.

The advantages of allowing expansion of section 1983 as a vehicle for post-conviction relief of state prisons outweigh the disadvantages. Among the potentially undesirable effects are harassment of innocent penal employees and an unwarranted aggravation of presently overcrowded federal dockets. These results can be minimized if states furnish post-conviction legal assistance for inmates. Courts then should apply punitive measures to prisoners who file frivolous petitions contrary to the advice of state-furnished counsel. The adverse effect of expanding section 1983 should be weighed against the realization that prisons cannot successfully prepare persons for return to society by allowing inmates to be deprived of federal rights while in confinement.

DAVID T. JOHNSON, JR.

## FLORIDA PROFESSIONAL ASSOCIATIONS AND SUBCHAPTER S*

Despite statutory recognition of the Professional Service Corporation by forty-seven states,[1] use of the corporate device by professions continues to be criticized.[2] Increased interest in incorporation by professionals results from the desire to obtain favorable federal tax treatment available to employees of a corporate entity. However, nontax considerations also contribute to the decision to operate as a Professional Association (P.A.) and help to legitimize entities that first appear to be created solely for tax advantage.[3]

This note will analyze the tax and nontax considerations concerning incorporation of law firms, especially as related to the Florida Professional Service Corporation Act.[4] Primary emphasis will be placed on tax treatment under Subchapter S of the Internal Revenue Code.[5] The discussion will concern only those parts of Subchapter S and general corporate tax provisions under Subchapter C[6] that are necessary for the operation of a law firm in Florida.

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* This note is a revision of a paper prepared for Professor J. J. Freeland's Federal Taxation Seminar.

1. *E.g.*, Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

2. Hobbet, *The Corporate Entity: When Will It Be Recognized for Federal Tax Purposes?*, 30 J. TAXATION 74, 75 (1969). These statutes designate such corporations as professional service corporations, professional associations or P.A.'s. For a list of states with P.A. acts *see* 5 P-H 1970 FED. TAXES ¶41,608, at 41,621.

3. *See* Deering, *Incorporation by Attorneys*, 42 ORE. L. REV. 93 (1963).

4. FLA. STAT. §621 (1967).

5. INT. REV. CODE of 1954, §§1371-79 [hereinafter cited as CODE].

6. CODE §§301 *et seq.*

At the outset, it is emphasized that incorporation as a P.A. is not a panacea for all Florida law firms; nor is the election under Subchapter S desirable in all cases. As a further caveat, the Commissioner may still attack the validity of a particular P.A. despite his reluctant acquiescense that most P.A.'s will be accorded corporate tax treatment.[7] Nonetheless, weighing the risks against the benefits, it may be advantageous to practice law as a P.A. and perhaps, in some instances, even more desirable to elect under Subchapter S.

Operation of a P.A. under Subchapter S has become less desirable because of recent congressional action. In the past, Congress has attempted to eliminate discrimination between employees and self-employed individuals with respect to fringe benefits;[8] however, the end product—the Keogh-Smathers Act — is less than satisfactory.[9] The Act bears little resemblance to the original bill that might have played a key role in reducing the relative desirability of corporate existence among professionals.[10] As a result, professionals have been left largely to their own devices; and the states have helped to fill the vacuum with the vehicle of the statutory P.A. The professional operating through a P.A. has been able to benefit from the special tax treatment given to employees with regard to pension and profit-sharing plans while simultaneously enjoying the tax benefits of Subchapter S treatment. The Tax Reform Act of 1969, however, provides that Subchapter S corporations may receive tax benefit only with pension and profit-sharing plans comparable to those specified in the Keogh-Smathers Act.[11] Thus, the generous pension and profit-sharing tax benefits once available to both Subchapter S and Subchapter C corporations are now effectively limited to Subchapter C corporations. Nevertheless, other tax incentives still may induce a firm operating as a P.A. to elect Subchapter S.

There is in addition to the problem of tax recognition, a question concerning the ethical propriety of practicing law as a corporation. At least two opinions of the American Bar Association Committee on Professional Ethics are particularly pertinent to P.A.'s.[12] In opinion 311, the committee sanctioned the use of 'Keogh" retirement plans even though such plans would involve profit-sharing.[13] These plans do not constitute "fee splitting," proscribed by canon 34 if profits are not a measure of the additional compensa-

7. T.I.R. No. 1019, 7 CCH 1969 STAND. FED. TAX. REP. ¶6867.

8. Self-Employed Individuals Tax Retirement Act, 76 Stat. 809 (1962), *incorporated in* CODE §§401 *et seq.*

9. The Self-Employed Individuals Tax Retirement Act limited the amount allowable as a deduction to one-half of the contribution (CODE §404(a)(10)), but this limitation was later repealed. The provisions now restrict the amount deductible to the lesser of $2,500 or 10% of earned income. CODE §404(e).

10. *See* Ray, *A Comparison of Tax Benefits Available Under H.R. 10 with Those Provided by Professional Associations*, 26 GA. B.J. 269 (1964).

11. Pub. L. No. 91-172, §531, 83 Stat. 654 (1969), (CODE §1379).

12. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, NO. 311 (1964); ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, NO. 303 (1961). *See also* FLA. BAR COMM. ON PROFESSIONAL ETHICS, OPINIONS, NO. 68-58 (1968).

13. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, NO. 311 (1964).

tion, but if only a contingent limitation on it.[14] In other words, a permissible profit-sharing plan must look only to the existence of profits as a contingency rather than as a measure of the amount to be contributed. Together, these opinions indicate that the practice of law as a properly organized P.A. is not per se a violation of the canons and employee profit-sharing plans may be properly established thereunder.

## THE PROFESSIONAL ASSOCIATION

### *Background*

In *Pelton v. Commissioner*,[15] a medical clinic formed as a trust was held to be an association taxable as a corporation. Ironically, the device[16] successfully utilized by the Commissioner against the taxpayer in *Pelton* has subsequently been employed to the advantage of taxpayers. In *United States v. Kintner*,[17] the taxpayer successfully asserted that his medical clinic should be taxed as a corporation. Two years later the Commissioner announced that he would not follow *Kintner*,[18] and in 1960 the Service attempted to close this legislative gap by promulgating what are now commonly referred to as the *Kintner* Regulations.[19] These regulations delineate the prerequisites for characterization as a corporation for tax purposes; they were amended in 1965 to exclude P.A.'s from corporate tax treatment.[20]

Subsequent to state legislation enabling P.A. formation, several cases in the federal district courts successfully challenged the Commissioner's disallowance of corporate level deductions taken by P.A.'s.[21] The Commissioner nevertheless refused to acquiesce. While its federal tax status was being litigated, the Florida supreme court recognized the validity of the P.A. for the practice of law.[22] Following taxpayer victories in the Fifth and Sixth Circuits,[23] the Commissioner conceded that most P.A.'s would be treated as corporations. Although the present situation is encouraging, ultimate crystal-

14. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 303 (1961).

15. 82 F.2d 473 (7th Cir. 1936).

16. CODE §7701; Treas. Reg. §§1.761-1 *et seq.* (1956), which define, *inter alia*, various taxable business entities.

17. 216 F.2d 418 (9th Cir. 1954).

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

19. Treas. Reg. §§301.7701-1, -2 (1960).

20. T.D. 6797, 1965-1 CUM. BULL. 553, which added ¶(h) to Treas. Reg. §301.7701-2 (1965). *See* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965), for an excellent discussion of the discriminatory effects the *Kintner* Regulations have on P.A.'s.

21. Wallace v. United States, Case No. LR-67-C-14 (E.D. Ark. Oct. 31, 1968); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 281 F. Supp. 359 (E.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1959); Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1968).

22. *In re* The Florida Bar, 133 So. 2d 554 (Fla. 1961).

23. Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969).

lization of P.A. status through congressional approval for federal tax purposes remains unlikely.

*Benefits Available to Professional Associations*

Since corporate formation and operation can be costly and burdensome, the offsetting fringe benefits not otherwise available to a partnership must be substantial before incorporation is justified. In addition to pension and profit-sharing plans, practicing law as a P.A. provides other benefits such as social security withholding in lieu of the self-employment income tax,[24] tax deductible group life and medical insurance,[25] up to one hundred dollars per week tax-free illness or injury pay under corporate financial plans,[26] tax-free payment by the corporation as reimbursement for medical expenses,[27] and up to 5,000 dollars in tax-free death benefits.[28] These benefits can produce substantial tax savings and deferral of income to the shareholder-attorney as well as to the nonshareholder employees of the firm. There are also attendant nontax benefits of corporate organizations. For example, shareholders are not personally liable for the negligence of other shareholders, except to the extent of the firm's assets,[29] and stock of a P.A. is more freely transferrable than a partnership interest.

*Pension and Profit-Sharing Plans*

Retirement pension and profit-sharing plans constitute the primary incentive for the incorporation of law firms. For attorneys with high incomes the great potential for deferral of tax liability is perhaps the most desirable feature of these plans. As they relate to P.A.'s, pension and profit-sharing plans should first be considered on their relative merits and second, with relation to the practical problems involved in implementing a workable plan.

The straight pension plan provides for fixed retirement benefits by requiring actuarially determinable contributions by the corporation until retirement.[30] Participants receive a fixed pension commonly funded by a trust. All amounts actuarially necessary are fully deductible by the corporation.[31] Participating employees are not taxed on the amounts contributed until receiving the fixed pension at retirement.[32]

Alternately, profit-sharing plans do not allow corporate deductions in excess of fifteen per cent of the total compensation paid;[33] however, they

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24. CODE §§1401 *et seq.*
25. CODE §79.
26. CODE §105 (d).
27. CODE §105.
28. CODE §101 (b).
29. FLA. STAT. §621.07 (1967).
30. Treas. Reg. §1.401-1 (b) (1) (i) (1946).
31. CODE §403 (a).
32. CODE §402 (a) (1).
33. CODE §404 (a) (3) (A).

offer other advantages that in some instances override this limitation. Unlike the straight pension plan, the profit-sharing plan requires corporate contributions only when there are profits. In such years the employer contributes a share of the annual profits to a trust, allocating an amount, which is usually related to compensation level and years of service, to the employees' individual accounts.[34] The amount of each employee's final benefits depends upon the total accumulation in his account during his years of participation.

Pension and profit-sharing plans also differ in that the former allow for "accelerated funding," whereby high contribution rates, fully deductible by the employer, are utilized to fund retirement plans for employees who become participants at an advanced age.[35] Consequently, a fixed benefit pension plan favors those employees closest to retirement at its inception.[36] Moreover, a pension formula can relate to past as well as future employee service, thus benefiting employees whose service began before the plan's inception.[37] Pension plans integrated with Social Security generally result in greater benefits to key employees than do integrated profit-sharing plans.[38] Unlike profit-sharing plans, pension plans permit discrimination with respect to factors such as age and sex where they affect the cost of retirement benefits.[39] Finally, pension plans encourage employees to remain with the firm since vesting of benefits may in some instances occur only at retirement.[40]

Conversely, profit-sharing plans favor participants who are the youngest at the inception of the plan because their accounts will accumulate for longer periods of time.[41] Profit-sharing plans offer more incentive to employees in situations where a major objective of the plan is to promote thrift and corporate savings,[42] and they are preferable in instances where the concentration of older employees would make the cost of funding pensions prohibitive. Finally, profit-sharing funds may vest immediately upon termination of employment. The latter consideration is especially important to younger associates of a firm,[43] since amounts contributed under pension plans would remain with the fund until retirement age notwithstanding prior termination of employment.

To qualify under section 401 of the Internal Revenue Code, any plan adopted must not discriminate in favor of officers, shareholders, or super-

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34. Treas. Reg. §1.401-1 (b) (ii) (1964).

35. Rev. Rul. 57-77, 1957-1 CUM. BULL. 158.

36. D. ROTHMAN, ESTABLISHING AND ADMINISTERING PENSION AND PROFIT-SHARING PLANS AND TRUST FUNDS 191 (1967).

37. *Id.* at 192.

38. *Id.* at 191. Retirement plans may exclude all employees who earn less than a specified salary without being discriminatory where benefits are supplemented under the Social Security Act. Treas. Reg. §1.401-3 (e) (1) (1956).

39. D. ROTHMAN, *supra* note 36, at 193.

40. D. ROTHMAN, *supra* note 36, at 196. *See generally* Norman, *Private Pensions, A Study of Vesting, Funding, and Integration,* 21 U. FLA. L. REV. 141 (1968).

41. D. ROTHMAN, ESTABLISHING AND ADMINISTERING PENSION AND PROFIT-SHARING PLANS AND TRUST FUNDS 193 (1967).

42. *Id.* at 196.

43. *Id.*

visory employees.[44] However, it may provide for forfeiture when a participant terminates employment prior to a vesting period,[45] usually set from five to ten years by the terms of the plan. The test for qualification is whether the over-all plan is nondiscriminatory in both operation and theory.[46]

Two practical problems occur when any plan is implemented concurrently with P.A. incorporation. First, all of the newly organized corporation's employees will have worked for the corporation for virtually the same period of time. Thus, although pension or profit-sharing plans ordinarily exclude employees who have worked for less than three to five years, here all employees will qualify under any length-of-service plan adopted regardless of their length of service with the prior partnership.[47] Consequently, the cost of including all employees may discourage immediate institution of such a plan. Second, the initiation of a pension or profit-sharing plan will necessitate a reduction in the take-home pay of participating employees. Appreciation of the long-range benefits may ease the burden; however, the immediate impact may be discouraging, if not prohibitive. These problems can best be solved through careful drafting and sufficient notice to the employees concerning the long-term benefits of the plan.

All proposed profit-sharing or pension plans must be submitted to the Internal Revenue Service for approval.[48] However, the Commissioner has consistently refused to act on plans submitted by P.A.'s. Thus, a P.A. should not rely on the Commissioner's silence, but should adopt a plan sufficiently conservative to prevent later disqualification for reasons other than the non-recognitions of P.A.'s generally.[49] *Wallace v. United States*[50] suggests one possible planning device for protecting against later disqualification. In *Wallace* the court upheld a P.A.'s profit-sharing plan despite a provision in the plan allowing the P.A. to recover all contributions in the event of disapproval by the Commissioner. Although the court restricted the operation of such language to an initial disapproval, P.A.'s may be well-advised to include a similar provision in their plans.

### *Formation of a Florida Professional Service Corporation for the Practice of Law*

To achieve corporate existence, a law partnership in Florida must comply with Florida Statutes, chapters 621 and 608.[51] While the statutes do not

44. CODE §401 (a) (4).
45. Treas. Reg. §1.401-7 (1963).
46. Grayck, *Tax Qualified Retirement Plans for Professional Practitioners: A Comparison of the Self-Employed Individuals Tax Requirement* [sic] *Act of 1962 and the Professional Association*, 63 COLUM. L. REV. 415, 425 (1963).
47. CODE §401 (a) (3).
48. Rev. Proc. 62-31, 1962-2 CUM. BULL. 517.
49. O'Neill, *Professional Service Corporations: Coping with Operational Problems*, 31 J. TAXATION 94 (1969).
50. 294 F. Supp. 1225 (E.D. Ark. 1968).
51. Law P.A.'s are becoming increasingly popular in Florida, although article XV of The Florida Bar Integration Rule and article XVI of The Florida Bar Bylaws impose re-

seriously affect the day-to-day operation of a law firm, they do significantly alter the interrelationship of shareholder-partners and associates. Liability of an individual attorney for the acts of his associates is limited by chapter 621. Of course, each attorney remains individually liable for negligence in services rendered to his clients;[52] however, unlike the usual joint and several liability imposed on partners, the shareholder-partner is liable for the acts of his associates only to the extent of his contribution to the capital of the corporation.[53]

Chapter 621 also expressly restricts the business of a P.A. to the "rendering of the professional services for which it was specifically incorporated."[54] However, the same section qualifies this restriction by allowing investment of "funds in real estate mortgages, stocks, bonds or any other type of investments," and it permits ownership of "real or personal property necessary for the rendering of professional services."[55] This section could reasonably be interpreted to preclude the use of a P.A. as an investment and holding company for business pursuits ancillary to the practice of law. Thus, shareholders should pursue their private investment opportunities outside the corporate entity.

Statutory alternatives for the identification of a P.A. as a corporation with limited liability are also provided by chapter 621. Corporate names containing the words "chartered" or "professional association" or the abbreviation "P.A." are permissible, while use of the words "company," "corporation," or 'incorporated" is expressly prohibited.[56] In lieu of identification by any of the permissible titles, a P.A. may register its name "to be so used in the manner required for the registration of fictitious names."[57] However, if the latter method is used, attorneys must reveal the incorporated nature of the firm to each client at the initiation of the attorney-client relationship.[58]

Establishing and operating a P.A. in Florida also requires compliance with the general corporation provisions of Florida Statutes, chapter 608.[59] Strict adherence to the statutory provisions may prove vital in both creation and day-to-day operations of the P.A. Periodic meetings of the board of directors as well as annual meetings of the stockholders should be held, with minutes recorded.[60] Annual reports must be filed[61] and an annual capital

strictions on their operation. Article XV requires directors to be members of The Bar and officers to be shareholders. A copy of the articles of incorporation must be filed with The Bar. Initial and annual reports must also be filed, as well as changes in the composition of shareholders, officers, or directors. Article XVI of the bylaws provides the necessary form for filing annual reports and for setting the filing fees.

52. FLA. STAT. §621.07 (1967).

53. *Id.*

54. FLA. STAT. §621.08 (1967).

55. *Id.*

56. FLA. STAT. §621.12 (1967).

57. *Id.*

58. FLA. BAR COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 68-58 (1968).

59. FLA. STAT. §621.13 (1967).

60. FLA. STAT. §§608.09-.10 (1967). *See* Frentz v. Commissioner, 44 T.C. 485 (1965), *aff'd*, 375 F.2d 662 (6th Cir. 1967); O'Neill, *supra* note 49, at 97-98.

stock tax paid,[62] and failure to comply with either requirement will deny the corporation access to state courts during the period of default.[63]

Considerable procedural flexibility is available to P.A.'s pursuant to part II of chapter 608,[64] relating to close corporations. It permits, among other things, acquisition of all shares of stock by one person,[65] management of the corporation by the stockholders rather than by a board of directors,[66] conduct of business without a meeting of the board of directors or executive committee,[67] conduct of business without a meeting by stockholders, and written side agreements relating to any phase of the affairs of the corporation.[68] Insofar as part II of chapter 608 does not conflict with the provisions of chapter 621, the former may be utilized in the operation of a P.A.[69]

*Tax Considerations*

From a tax standpoint, the formation of a P.A. presents little difficulty. Generally, the transfer of assets from an existing law partnership into a corporation is a tax-free transaction, provided no boot is involved.[70] However, treatment of uncollected accounts receivable may present special problems. Assuming the partners are cash basis taxpayers, accounts receivable may be transferred in at a zero basis if there is no attempted evasion of taxes.[71] The possibility remains, however, that the Commissioner may seek reallocation of income based on assignment of income principles.[72] In that event, gain would be recognized and taxable to the partners at the time of transfer. Election under Subchapter S at the time of formation might circumvent the assignment of income problem, for such income would, in any event, be taxed to the shareholders. Another approach is to retain the accounts receivable in the existing partnership, reporting income to the partners as collected. Under this method, the initial earnings of the P.A. would be reduced, thus lowering initial contributions to profit-sharing plans. However, this consideration may be inconsequential when weighed against the high gain potentially recognizable under the former approach. Therefore, if the partnership desires a tax-free transfer of assets, it should be prepared to continue partnership existence until its existing accounts receivable are extinguished.

61. FLA. STAT. §608.32 (1967).
62. FLA. STAT. §608.33 (1967).
63. FLA. STAT. §608.35 (1967).
64. FLA. STAT. §§608.0100 *et seq.* (1967).
65. FLA. STAT. §608.0101 (1967).
66. FLA. STAT. §608.0102 (1967).
67. FLA. STAT. §608.0103 (1967).
68. FLA. STAT. §608.0105 (1967).
69. FLA. STAT. §621.13 (1967). Careful consideration must be given, however, to possible loss of essential characteristics of "corporateness" necessary under the *Kintner* Regulations as a result of avoiding these formalities. *See also* T.I.R. No. 1019, 7 CCH 1969 STAND. FED. TAX. REP. ¶6867.
70. CODE §351 (1954).
71. Briggs v. Commissioner, 15 T.C. Mem. 440 (1956).
72. *See* Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

Finally, tax consideration should be given to the business investments of a P.A. since they may run afoul of the accumulated earnings and personal holding company tax provisions.[73] Moreover, a P.A. electing to be taxed under Subchapter S may inadvertently terminate its election if it receives excessive passive investment income.[74] This latter consideration again emphasizes that business investments, in most cases, should be conducted outside the corporate entity.

### *The Tax Outlook*

The courts have consistently held that uneven application of the *Kintner* Regulations to P.A.'s is clearly discriminatory. In *Empey v. United States*,[75] the first case to construe the *Kintner* Regulations, the court held that "the treasury regulations are inconsistent with the statute and the judicial construction thereof and . . . the regulations constitute the exercise of a non-delegable legislative function . . . [and are] invalid and unenforceable."[76]

In *O'Neill v. United States*[77] the court concluded that there was no legislative or judicial support for imposing more strenuous standards of corporate tax treatment on professional service organizations than on all other kinds of organizations. Accordingly, that portion confining its holding to the part of the *Kintner* Regulations specifically dealing with P.A.'s[78] was held invalid. Shortly thereafter, three other cases also condemned the same portion of the regulations.[79]

The most recent case to construe the *Kintner* Regulations as they apply to P.A.'s is *Kurzner v. United States*.[80] In *Kurzner* the Government contended that a Florida medical group organized as a P.A. was in fact a partnership for federal tax purposes. Once again, the portion of the regulation specifically dealing with P.A.'s[81] was held invalid. The court noted, however, that merely incorporating as a P.A. would not in itself permit such entities to be taxable as corporations. Thus, qualification as a corporation under state law will not conclusively establish an entity's tax status.[82]

The court set out four criteria for gaining corporate tax treatment: continuity of life, centralization of management, limited liability, and free transferability of interests. In applying the continuity of life test to the Florida Professional Service Corporation Act and ultimately to the medical group in question, the court concluded that "a professional service corporation is not

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73. CODE §§531, 541.

74. CODE §1372 (e) (5).

75. 272 F. Supp. 851 (D. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1969).

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

77. 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969).

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

79. Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd*, 412 F.2d 1189 (5th Cir. 1969); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969).

80. 413 F.2d 97 (5th Cir. 1969), *aff'g* 286 F. Supp. 839 (S.D. Fla. 1968).

81. Treas. Reg. §301.7701-1 (h) (1965).

82. 413 F.2d 97 (5th Cir. 1969). *See also* Roubik v. Commissioner, 53 T.C. No. 36 (1969).

substantially different from any other corporation in this regard, and it is perfectly identical to nonprofessional service corporations."[83] With regard to centralization of management, the court stated that since the board of directors is the governing body of the corporation,[84] there is at least an opportunity for centralized management. Moreover, policy and direction of a professional service corporation emanates from a centralized body,[85] and thus, meets the centralization of management standards of corporateness. Personal liability was said to be limited in a professional corporation to the same extent as in any other corporation, notwithstanding that shareholder-professionals are not immune from liability for their own conduct. Shares of a professional corporation were found to be as freely transferable as many, if not most, closely held corporations.[86] The court concluded that the medical group in question substantially complied with most of the criteria of the original *Kintner* Regulations[87] and should therefore be accorded corporate tax treatment.

Language in *Kurzner* apparently allows operation of one-man professional corporations. The court refers to an opinion of the attorney general of Florida indicating that a professional service corporation can be formed by a single incorporator.[88] It would appear that one-man operations would not satisfy the *Kintner* Regulations since they lack continuity of life. The court stated in dictum, however, that if an organization is not large enough to ensure continuing the operation or to entice someone into the business, it could not continue to function as an enterprise, and thus the question would be moot.[89]

The thrust of *Kurzner* is two-fold: it adds support to the increasing number of cases invalidating the latter part of the *Kintner* Regulations, and it contains dicta that lends support to the operation of P.A.'s by single individuals.

## THE SUBCHAPTER S ELECTION

### *In General*

After a law firm has decided to become a professional association, it must decide whether to be taxed at both the corporation and shareholder levels as a "regular" corporation under Subchapter C of the Internal Revenue Code or at the shareholder level alone as a "pseudo-corporation" under Subchapter S.[90]

83. 413 F.2d at 107.
84. FLA. STAT. §608.09 (1967).
85. 413 F.2d at 106.
86. *Id.* at 107.
87. Treas. Reg. §§301.7701-1, -2 (1960).
88. [1961-1962] FLA. ATT'Y GEN. BIENNIAL REP. 187.
89. 413 F.2d at 107. Of course, the sophisticated tax advisor should remain concerned about the lurking applications of §§269 and 482.
90. This resemblance of Subchapter S to partnership taxation principles is the reason for the name "pseudo-corporation." The only instance of an income tax at the corporate

Crucial to the decision to elect under Subchapter S is consideration of section 1379, recently enacted as part of the Tax Reform Act of 1969.[91] This section requires stockholder-employees who own more than five per cent of the stock of a Subchapter S corporation to include in their gross income any contributions made on their behalf by the corporation under a qualified plan to the extent such contributions exceed the lesser of ten per cent of compensation or 2,500 dollars.[92] Employees or stockholders who own five per cent or less of the stock are not subject to this limitation. In contrast to the Keogh-Smathers Act, section 1379 does not provide that excessive contributions on behalf of stockholder-employees affect the qualified status of the plan.[93] If the stockholder-employee or his beneficiaries do not receive amounts previously included in gross income as the result of excess contribution, a deduction is allowed equal to the amount previously included but not recovered.[94] This may occur where the employee terminates employment or where he or his beneficiaries are receiving payments from the plan but, because of the employee's death, recover less in the aggregate than the amount previously included in his gross income.

In deciding whether to elect under Subchapter S, strong consideration should be given to the impact of section 1379. Despite the restrictions on pension and profit-sharing plans, elimination of the double tax and other benefits available may still make the Subchapter S election desirable. Moreover, a Subchapter S 401-type plan continues to retain some advantage over the conventional Keogh-Smathers plan.

According to the congressional committee report, the purpose of Subchapter S is to allow small businesses to select their type of business organization independent of tax considerations.[95] However, the operation of a Subchapter S corporation is complex, requiring constant planning and supervision from both accounting and tax standpoints. The requisites of the Internal Revenue Code must be strictly followed in order to avoid an unintentional loss of the election.[96] Thus, despite congressional efforts to effect the original purpose of Subchapter S, the result has been an increase in the tax considerations attendant to the selection of a business form.[97]

A corporation must meet four basic requirements in order to elect under Subchapter S:[98] there must be no more than ten shareholders; only individuals or estates may be shareholders; nonresident alien shareholders are prohibited; and only one class of stock is allowed. In addition, the consent of all share-

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level under Subchapter S is for excessive capital gains under §1378. *See generally* Note, *Interrelationship of Subchapter S and Subchapter C*, 22 U. FLA. L. REV. 415 (1970).

91. Pub. L. No. 91-172, §531, 83 Stat. 654 (1969).

92. CODE §1379 (b) (1).

93. S. REP. No. 91-552, 91st Cong., 1st Sess. 216 (1969).

94. CODE §1379 (b) (3).

95. S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958).

96. Frentz v. Commissioner, 44 T.C. 485 (1965), *aff'd*, 375 F.2d 662 (6th Cir. 1967).

97. Many of the complexities of Subchapter S are eliminated in its proposed revisions. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 716 (1966).

98. CODE §1371.

holders is required for valid election.[99] The requirement that there be no more than ten shareholders may be determinative in the decision to elect under Subchapter S if the number of policymaking partners already exceeds ten. Compliance with the rule that all shareholders must be individuals or estates is easily accomplished, especially in light of preexisting restrictions imposed on P.A.'s by chapter 621 of the Florida Statutes.[100] The requirement that there be only one class of stock is highly susceptible to inadvertent breach. The regulations describe several ways in which a second class of stock may arise,[101] including disproportionate rights and interests with respect to certain shares of stock, and obligations that purport to represent debt but actually represent equity capital.[102] Finally, timely consent is necessary to effect and preserve the election under Subchapter S.

Treasury Regulations setting out the manner of exercising the election[103] require the P.A. to submit form 2553 and a statement of the consent from each shareholder to the District Director of the Internal Revenue Service. To be effective in the taxable year submitted, the election must be made during the first month of such taxable year or during the preceding month. Once made, the election cannot be revoked for the same taxable year; however, this result can be achieved by deliberate breach of the requirements of Subchapter S. Pursuant to section 6037, an annual information return on form 1120S must be filed by the P.A.

The recent case of *Leonhart v. Commissioner*[104] should be considered in the ultimate decision to become a P.A. with possible election of Subchapter S. The Tax Court held that the return filed by a Subchapter S corporation did not start the running of the statute of limitations, since it was merely an information return and not a tax return.[105] Thus, the Commissioner can assess a deficiency based on information relating to a Subchapter S corporation at any time in the future. This decision might be considered sufficiently onerous to discourage election under Subchapter S.

*Special Considerations for Electing Professional Associations*

While the operation of a P.A. under Subchapter C has obvious tax advantages over unincorporated practice, an election under Subchapter S, in addition, prevents the application of all taxes imposed on corporations by chapter I of the Internal Revenue Code.[106] Among the taxes eliminated are: the corporate income tax under section 11, the accumulated earnings tax under section 531, and the personal holding company tax under section 541. The

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99. CODE §1372 (a).

100. FLA. STAT. §621.11 (1967). Shares in a law P.A. may be sold or transferred only to other individuals licensed to practice law.

101. Treas. Reg. §1.1371-1 (g) (1968).

102. *See* Gamman v. Commissioner, 46 T.C. 1 (1966).

103. Treas. Reg. §1.1372-1 (1968).

104. 27 Tax Ct. Mem. 443 (1968).

105. The court noted that a tax was imposed on excessive capital gains by CODE §1378.

106. CODE §1372 (b) (1).

only exception is the tax on excessive capital gains.[107] In addition, P.A.'s electing under Subchapter S are not troubled with problems concerning assignment of income to the corporation by shareholders.

The most obvious benefit of the S election is the elimination of income tax at the corporate level. Corporate income is taxed directly to the shareholders in the form of distributions and undistributed taxable income (UTI),[108] which is a constructive dividend equal to the shareholder's portion of the P.A.'s taxable income less the sum of any section 1378 tax and *money* distributed as dividends during such year.[109] UTI increases shareholder income without actual receipt of payment. Since a P.A. is entitled to income deductions for salaries, contributions to section 401 retirement plans and other ordinary and necessary business expenses, taxable income may be reduced to a negligible amount. Thus, for certain P.A.'s the S election may not be worthwhile. Eventually, however, when deductions no longer adequately offset taxable income, Subchapter S begins to allow substantial tax savings, and a qualified P.A. should then elect under it.

Another advantage of the S election is elimination of the accumulated earnings tax,[110] which is imposed to penalize a corporation that withholds excessive amounts of corporate earnings and profits from distribution to its shareholders. Under Subchapter S, however, the constructive dividend of UTI makes it impossible for the P.A. to shield earnings from taxation at the shareholder level by retaining them. Thus, the policy behind the accumulated earnings tax provision is effectuated by electing under Subchapter S. Any P.A. that declines to elect under S, though it may never actually become subject to the accumulated earnings tax[111] nevertheless remains eligible for such liability in proper circumstances.

A third benefit of the S election is elimination of the personal holding company tax[112] that threatens small P.A.'s having personal service income within the meaning of section 543 (a) (7). Amounts received by a shareholder who owns twenty-five per cent or more of the outstanding stock constitute personal service income if clients or other persons outside the P.A. have the right to specify that this particular shareholder represent them. The same result occurs if the shareholder is named in a contract for his services. However, merely generating personal service income does not mean that the seventy per cent personal holding company tax will be imposed. The P.A. must also meet the two-part definition of a personal holding company[113] that requires ownership during the last half of the corporate taxable year of more than fifty per cent of the outstanding stock by five or fewer individuals,

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107. CODE §1378.

108. As a constructive dividend UTI causes all corporate income to be taxed to the shareholders, whether actually distributed or not. CODE §1373 (c).

109. CODE §1373 (c).

110. CODE §531.

111. CODE §535 (c) provides a credit of at least $100,000 to be used in determining the accumulated taxable income under §535 (a).

112. CODE §541.

113. CODE §542.

coupled with personal holding company income that constitutes at least sixty per cent of the P.A.'s adjusted ordinary gross income. A P.A. with twenty-five per cent shareholders must scrupulously avoid satisfying the definition of a personal holding company in order to escape the penalty tax. This can be accomplished simply by electing under Subchapter S.

Finally, the assignment of income theory is not applicable in the elective Subchapter S situation because all the P.A.'s income, including undistributed income, is taxed to the shareholders. Thus, shareholders cannot avoid taxation of all the income derived from their services by retaining the income in the P.A. Conversely, a P.A. that did not elect Subchapter S could be vulnerable to application of assignment of income principles if it retained inordinately large amounts of income.

These tax considerations, which make the Subchapter S election almost imperative for a small P.A., do not apply with equal strength to larger P.A.'s. For example, there is no danger of the personal holding company provisions being applied if *each* shareholder owns less than twenty-five per cent of the stock. This benefits the client as well as the firm because the client is free to designate who may represent him. Additionally, assignment of income problems would be lessened because the numerous shareholders would assure more arms-length dealings. The accumulated earnings tax would still be applicable if the 100,000 dollar credit were exceeded: however, careful planning can minimize this danger through timely dividend distributions.

Subchapter S election may be unattractive to certain P.A.'s because participation in important policy matters such as dividends, salaries, office procedure, and future growth would be limited to a maximum of ten persons.[114] A large firm, in which policymaking authority has been vested in more than ten members, might be unable to elect under S because no one may be willing to relinquish his influence. The election may also be undesirable for a firm planning expansion if it anticipates that more than ten persons will govern the firm.[115]

The limit on shareholders does not require a similar limitation on participation in profit-sharing by the members of the P.A. On the contrary, it is possible for even the most junior members to be eligible for a share in the profits. For example, each lawyer could be assigned part of the firm's overhead in an amount varying with his seniority or his income-producing ability. The sum of the dollar amount of overhead and his straight salary would constitute his "incentive basis," and to the extent that his total fees earned exceeded his incentive basis, he would receive a bonus equal to a percentage of such excess. This percentage would become larger as his seniority with the firm increased. Because such bonuses are deductible in computing

114. CODE §1371 (a) (1).

115. Where husband and wife own the stock jointly, it is possible to expand the governing authority to eleven persons and still preserve the Subchapter S election because for this purpose the regulations consider the spouses as one shareholder. Treas. Reg. §1.1371-1 (d) (2) (1968). However, this would only be possible if both spouses were lawyers.

taxable income of the P.A.,[116] they reduce UTI.[117] The excess over the incentive basis that is not paid in bonuses would be added to a pool to fund dividends. This bonus plan allows immediate sharing in profits, and, since the profits are paid to employees currently, the plan is not within section 401. Thus, the plan presents no discrimination problem even though only lawyer-employees participate.

Among the advantages of this bonus plan is that it can be easily blended with section 401 plans by increasing the incentive basis by the amount of anticipated contributions to pension or profit-sharing plans. This would assure the funding of retirement plans before any bonuses are paid, however, the plan should, in any event, specifically so provide.[118] Another advantage is that the bonus plan automatically eliminates the problem of stating a definite salary in the employment contract, thus reducing the economic strain resulting from high fixed salaries.

Subchapter S election specially permits pass-through of corporate capital gains, which allows each shareholder to treat as capital gains that portion of his dividends (both actual and constructive) that equal his prorata share of the excess of corporate net long-term capital gains over net short-term capital losses.[119] The only limitation is that to the extent such excess exceeds corporate taxable income or the amount of dividends exceeds current earnings and profits, ordinary income results. This provision would most often operate where the P.A. owns its own office building and later sells it at a profit. The capital gains treatment of the gain realized would be passed directly to the shareholders.

Since substantial gain may result from the sale of an office building, the P.A. may be subjected to the tax on excessive capital gains under section 1378. This tax is applicable if the excess of the long-term gains over the short-term losses exceeds fifty per cent of the P.A.'s taxable income. In some cases, this tax can be avoided by using the installment sales provisions of the Code to spread the gain over several years.[120] Where the tax cannot be avoided, the amount of the tax is subtracted from the excess of long-term gains over short-term losses, resulting in a reduced pass-through of capital gains to the shareholders.[121]

Subchapter S also allows a possibility for tax deferral available to shareholders of a P.A. By choosing a taxable year different from that of the P.A.,[122] a shareholder may, to a limited extent, select the year in which the P.A.'s earnings will be included in his own individual return. For example, assume that a shareholder on a calendar tax year works for a P.A. with a fiscal year

116. Treas. Reg. §1.162-9 (1958).

117. CODE §1373 (c).

118. O'Neill, *Professional Service Corporations: Coping with Operational Problems,* 31 J. TAXATION 94, 96 (1969).

119. Treas. Reg. §1.1375-1 (b) (1968), provides a convenient ratio to determine the amount of capital gain passed through to each shareholder.

120. CODE §453.

121. CODE §1375 (a) (3).

122. CODE §441.

ending March 31, 1969. During the last nine months of 1969 a distribution will be taxed to the shareholder in that year. However, a distribution in the first three months of his 1970 taxable year is taxable to him in 1970, even though both distributions were made in the same fiscal year. Thus, when a shareholder's tax liability has reached the maximum desired, he can withhold further distributions until his next tax year, thereby deferring his liability until that time without creating assignment of income problems.

*Distributions by the Electing Professional Association*

In addition to the incentive basis method of current profit-sharing by all members of a P.A., shareholders may receive taxable dividends[123] based on their ownership interests during the year. As previously mentioned, an electing P.A. is not a taxpaying entity.[124] Its taxable income is taxed directly to the shareholders whether actually distributed or not, and any undistributed taxable income (UTI) not distributed as money dividends during the P.A.'s taxable year is taxed to the shareholders as a constructive dividend. When the tax on UTI is imposed, the UTI becomes *previously taxed* undistributed taxable income (PTUTI) and is recorded in a separate account for each shareholder. Actual cash distributions, up to the value of the PTUTI account can then be made tax free in subsequent years.[125]

With one exception, PTUTI may be distributed only after the distribution of current earnings and profits.[126] Thus, it is difficult to determine how much PTUTI was distributed in any year until the close of that year when the amount of current earnings and profits is known. However, it is then too late to distribute any remaining PTUTI not already paid out. This problem is solved by the exception in section 1375 (f), which allows an immediate payout of PTUTI (ahead of current earnings and profits) during the first two and one-half months of the P.A.'s taxable year. Such a distribution is treated as a reduction of UTI for the preceding taxable year, and it may be made only to the extent of UTI declared in such year. Further, because it is not a dividend, PTUTI does not reduce UTI for the taxable year in which it is undistributed.[127] As commentators have observed, PTUTI is a form of privileged capital.[128] Section 1375 (f) allows it to be distributed ahead of current earnings and profits and it always has priority over accumulated earnings and profits. Distributions in excess of the sum of current earnings and profits and PTUTI are dividends to the extent of any accumulated earnings and profits. Beyond this, distributions are a return of capital.[129]

Since the shareholder cannot escape taxation on his share of the P.A.'s

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123. *See* CODE §301 (c) (1).

124. CODE §1372 (b), other than the tax on excessive capital gains.

125. CODE §1375 (d) (1).

126. Treas. Reg. §1.1375-4 (b) (1968).

127. CODE §1373 (c).

128. *E.g.*, Note, *"Locked-In Earnings" — How Serious a Problem Under Subchapter S?*, 49 VA. L. REV. 1516, 1521 (1963).

129. CODE §301 (c); Treas. Reg. §1.1375-4 (b) (1968).

income, it is prudent to make sufficient distributions during the year and use the anti-blunder provision of section 1375 (f) to reduce UTI to zero. This procedure has two benefits. First, it avoids a constructive dividend that increases the shareholder's taxable income without an actual payment, thus making it difficult to pay the tax imposed on his income. Second, it avoids creating PTUTI and the concomitant risk that a shareholder's portion of PTUTI may become "locked in" if either his interest in the P.A. or the P.A.'s election under Subchapter S terminates. PTUTI is said to be "locked in" when it cannot be paid out to a shareholder as a tax-free distribution. This condition arises in two situations. While the Subchapter S election is effective, a shareholder will be unable to collect his share of PTUTI if he dies or disposes of all his stock, because PTUTI is personal to him and cannot be transferred to another party.[130] Moreover, if the Subchapter S election terminates, the privileged capital character of PTUTI lapses and any post-termination distribution is taxed as a dividend to the extent that the P.A. has accumulated earnings and profits.

The principal objection to reducing UTI is the fear that the necessary money distributions may excessively drain liquidity. However, this consideration is minimal with a P.A. because its income is usually in cash and there is little need to retain earnings for reinvestment in the business. In this respect a law practice lends itself well to operation under Subchapter S.

Payment of fees by a client in shares of stock, bonds, personal property, or realty presents a special problem to a Subchapter S professional association because only money dividends reduce UTI.[131] If there is a substantial likelihood that the property will appreciate in value, the P.A. can retain it for a maximum of fourteen and one-half months[132] and still realize capital gains through its disposition. These gains will be passed through to the shareholders under section 1375 (a). As attractive as this procedure may appear, it should not be attempted unless the property is readily salable and the gain realized will cover its carrying costs (for example, taxes on realty).

On the other hand, if there is little chance of appreciation in value, the firm should either have its client convert the property to cash before settlement of the fee or should sell it immediately upon receipt. Such sale by the firm would produce no gain since the sale price would equal the firm's fair market value basis in the property. Since the client must recognize any gain, it would make no difference to him whether the asset is transferred in kind or converted before payment of the fee.[133]

One aspect of a Subchapter S election may cause some added tax to the shareholders even if only money dividends are paid. Under section 6015 (a) (2), each shareholder must make a declaration of estimated tax if

130. Treas. Reg. §1.1375-4 (e) (1968). However, if the stock is disposed of during the shareholder's lifetime he can "recapture" his PTUTI if the stock is subsequently reacquired during the same election. *Id.*

131. CODE §1373 (c).

132. This period includes the taxable year plus the two and one-half months' grace allowed by CODE §1375 (f).

133. *Cf.* United States v. Davis, 370 U.S. 65 (1962).

his dividends for his taxable year can reasonably be expected to exceed 200 dollars, and must pay a six per cent penalty if he underpays his estimated tax.[134] The fact that the shareholders may be unable to make a sufficiently accurate estimate of total dividends (a possible occurence especially during the first year of operation when there is no earnings history) provides no basis for relief.[135] However, dividends can be minimized by use of the bonus plan previously discussed.

*Termination of the Subchapter S Election*

Generally, four events may cause termination of the Subchapter S election:[136] revocation of the election,[137] failure of new shareholders to make timely consent,[138] failure of the P.A. to conform to the definition of a small business corporation,[139] and excessive passive investment income.[140] A revocation voluntarily terminates the election. To be effective for the taxable year in which made, a revocation must occur during the first month of such year. Otherwise, it is ineffective until the succeeding taxable year. The other three events cause involuntary termination of the election for failure to comply with its requirements. They are effective for the same taxable year in which the proscribed event occurs.

The deliberate revocation of the election is somewhat cumbersome because it requires the consent of all current shareholders, and it cannot be made until after the initial year of operation under Subchapter S. To obtain the maximum benefit from the revocation procedure, a P.A. should review its election during the first month of each taxable year so that a decision to revoke can be effective in that year. Possible reasons for revoking the election are to extend the firm's decisionmaking power to more than ten persons, to accumulate earnings without having PTUTI, to permit shareholder-employees to contribute to pension and profit-sharing plans without the limitations of section 1379, and to allow certain shareholders to reduce their personal income tax brackets by not having UTI taxed to them each year. In the latter case, the unanimous consent requirement for a revocation will cause difficulty if other shareholders with lower tax brackets prefer to continue the Subchapter S election.

If unanimous consent of all shareholders is unavailable or if the first month of the taxable year has passed, a termination effective in the current taxable year can only be achieved by an intentional violation of another provision of section 1372 (e). The nature of the statutory tests, however, allows a choice to P.A.'s aware of their existence. Thus, section 1372 (e) (1), which

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134. CODE §6654 (a).

135. Rev. Rul. 62-202, 1962-2 CUM. BULL. 344.

136. A fifth event, when more than 80% of gross receipts comes from sources outside the United States, as provided in §1372 (e) (4), is not particularly applicable to P.A.'s.

137. CODE §1372 (e) (2).

138. CODE §1372 (e) (1).

139. CODE §1372 (e) (3).

140. CODE §1372 (e) (5).

requires an immediate termination if a new shareholder fails to consent to the election within thirty days of becoming a shareholder,[141] may be used where a voluntary revocation is not possible. The technique often used is sale of one share of stock to another lawyer in the P.A. who deliberately fails to make a timely consent. However, this procedure results in a slight dilution of control, which may be undesirable to the shareholders; and it may be susceptible to attack by the Commissioner as a sham if prompted solely for purposes of tax avoidance.[142]

Because the provisions of Subchapter S are largely mechanical, they are usually strictly construed. Therefore, a P.A. desiring to preserve its election should make certain that prospective shareholders will comply with the consent requirement before they actually become shareholders. Even the estate of a deceased shareholder is considered a new shareholder for this purpose and must give the requisite consent to prevent termination.[143] To avoid an unintentional revocation, each shareholder should direct his executor to file a timely consent.

Because of the requirement that only an individual (other than a decedent's estate) may be a shareholder, estate planning is also important to prevent termination for failure to conform to the definition of a small business corporation. A deceased shareholder's stock may be held by his estate during the period of administration or until disposed of to a qualified purchaser. However, unreasonable delay in the administration of the estate may terminate the Subchapter S election.[144] If a shareholder desires to preserve the election, he cannot leave his shares to a testamentary trust after his death, nor can he use a grantor trust to reduce his probate estate during his life.[145] Moreover, under Florida law[146] only lawyers may own shares in a P.A. practicing law. Thus, a shareholder may not bequeath his shares to laymen without risking dissolution of the P.A. Probably the wisest procedure is an agreement providing either for stock redemption by the P.A. upon a shareholder's death or for purchase of his stock by the surviving shareholders. Redemption by the P.A.. may be funded by insurance on each shareholder taken out by the P.A. Since premiums on such insurance are not deductible by the P.A.,[147] this in turn creates UTI at the end of the year because the amount of premiums is no longer available to be paid as dividends. Consequently, at the beginning of the next taxable year, each shareholder would acquire PTUTI, which would remain with him throughout his tenure with

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141. Treas. Reg. §1.1372-3 (b) (1964). However, an extension of time for filing consent is available under Treas. Reg. §1.1372-3 (c) (1964), upon a showing of reasonable cause for failure to file a timely consent.

142. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 717 (1966).

143. Rev. Rul. 62-116, 1962-2 Cum. Bull. 207.

144. Old Virginia Brick Co. v. Commissioner, 44 T.C. 519 (1965), *aff'd*, 367 F.2d 276 (4th Cir. 1966) (shares held to have passed to trust).

145. Treas. Reg. §1.1371-1 (e) (1968).

146. Fla. Stat. §621.11 (1967).

147. Code §264 (a) (1).

the firm. However, the redemption agreement could provide for an upward adjustment in the purchase price of shares by the amount of each shareholder's PTUTI. Since the stock basis was previously increased to reflect the PTUTI,[148] this increase in purchase price would not create a greater tax liability. If a specific purchase price is provided in the agreement, it may not represent the fair market value of the stock at the shareholder's death. To avoid this problem, the price should be stated in terms of the shareholder's percentage interest in the value of the P.A. rather than a dollar amount. Even then, the formula should be reviewed periodically.[149]

Like the new shareholder consent requirement, the small business corporation test[150] invites deliberate violation. For example, a sale of shares to more than ten persons may terminate the Subchapter S election. Although this would pose no difficulty for an already large firm, it may be totally unacceptable to a smaller firm if it would cause the original owners to sacrifice control. Presumably, termination could also be accomplished by placing one share into a grantor trust. This may be more desirable than a sale because there is no dilution of control.

The existence of a second class of stock may also violate the small business corporation test,[151] even without the actual issuance. Unintentional creation of a second class of stock, however, such as where there are voting rights disproportionate to stock holdings,[152] may cause unanticipated problems. For example, a P.A. desiring to expand its offices seeks a loan from its shareholders, it risks having the loan declared a second class of stock. In *Gamman v. Commissioner*,[153] the shareholders' loan to their thinly capitalized Subchapter S corporation was held to be "disguised equity." However, no termination of the Subchapter S election occurred because the loans were proportional to the shareholders' interests. The pertinent Treasury regulation held invalid by the Tax Court, provided that a purported debt that is not really a debt must be stock.[154] The regulations have since been amended to conform to *Gamman* and now provide that purported debt obligations will be treated as contributions to capital (rather than a second class of stock) insofar as the debt remains proportional to the shareholders' stock holdings.[155] However, it would be unwise to assume that a debt proportional to stock holdings will never be declared a second class of stock. The regulations do not have the force of law and the factual question whether a purported debt is really debt or equity capital must be decided in each case.[156] To be safe, any

148. CODE §1376 (a); this assumes that the basis had not previously been reduced by net operating losses.

149. Green, *Planning for Corporate Stock Redemptions Faces Many Potential Hazards*, 19 J. TAXATION 2, 3 (1963).

150. CODE §1372 (e) (3).

151. Treas. Reg. §1.1371-1 (g) (1968).

152. FLA. STAT. §608.0105 (1967).

153. 46 T.C. 1 (1966).

154. Treas. Reg. §1.1371-1 (g) (1959).

155. Treas. Reg. §1.1371-1 (g), *as amended by* T.D. 6904, 1967-1 CUM. BULL. 219.

156. 46 T.C. at 11.

loan to a P.A. by its shareholders should be proportional to their stock holdings. The loan should be bona fide, with provisions for repayment, stated interest, and nonsubordination to other debts.

Finally, an immediate termination can result if the P.A. has passive investment income in excess of twenty per cent of its gross receipts for the taxable year.[157] Sources of passive investment income common to P.A.'s include rents and gains from sales of stock. If a P.A. owns an office building that is leased to tenants, the payments received will be rents within the meaning of section 1372 (e) (5) unless "significant services" are also rendered to the tenants primarily for their convenience.[158] Apparently, such services must be personal to each tenant; however, the regulations do not further explain the term except to say that maid service is one example. Therefore, a P.A. might prevent its rents from being passive income by providing a janitorial service to clean each tenant's offices. P.A.'s that invests their funds in stocks must also be careful to avoid excessive earnings from investments because all such earnings are passive income.

*Liquidation*

If a professional association desires to conclude its business affairs or return to partnership practice, it is important to select the method of liquidation most beneficial to the P.A. and its shareholders. Generally, amounts distributed to shareholders are treated as received in full payment or exchange for the stock, and gain or loss will be recognized according to the basis of the stock.[159] However, recognition of gain to the shareholders may be limited. Section 333 of the Internal Revenue Code allows a corporation with no earnings and profits to liquidate with no recognition of the gain realized by the shareholders. This provision would be attractive to a P.A. only at the beginning of its taxable year, when earnings and profits are negligible, because each shareholder is required to recognize his gain as ordinary income to the extent of his share of earnings and profits.[160]

Since a P.A. electing under Subchapter S does not pay tax on its gain, it need not necessarily be concerned with liquidating under the time-clock of section 337. Moreover, since it has no inventory assets, a P.A. would probably realize capital gains or 1231 gains on the sale of its assets. These gains could be passed through to the shareholders. Ordinary income, however, would result from the sale of its receivables, and would also be passed through to the shareholders. A deciding factor, therefore, may be whether the corporate basis in the assets is higher or lower than the shareholders' basis in their stock.[161] If the corporate basis is higher, sale by the P.A. outside of section

157. Treas. Reg. §1.1372-4 (b) (5) (i) (1968). The term "gross receipts" is broader than gross income. Treas. Reg. §1.1372-4 (b) (5) (iv) (1968).

158. Treas. Reg. §1.1372-4 (b) (5) (vi) (1968); *cf.* Treas. Reg. §1.1402 (a)-4 (c) (2) (1963), which uses substantially the same services test to include rentals from living quarters in self-employment income.

159. CODE §§331, 1001.

160. CODE §333 (e).

161. B. BITTKER & J. EUSTICE, *supra* note 142, at 736.

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337 is more desirable. Other advantages of avoiding liquidation under section 337 are the limited possibility of using section 333 and the availability of the installment sales method.[162] The latter is attractive if the P.A. owns any realty. Gains from the installments can also be passed through to the shareholders.[163] However, if the existence of the corporation becomes uncertain during the time the assets are being sold, there may be a problem since such existence is necessary to maintain the Subchapter S election. Thus, it would seem advisable for the P.A. to remain in existence throughout this procedure by leasing back or renting needed assets. On the other hand, section 337 will minimize the gain if the basis of the shareholders' stock were higher than the basis of the assets to the corporation, and may nullify an otherwise unavoidable capital gains tax under section 1378.

## CONCLUSION

From a tax standpoint and otherwise, the numerous advantages to the practice of law in the form of a professional association merit serious consideration by most law firms. Deferred compensation plans, the most publicized benefit, are the principal reasons for the increased popularity of P.A.'s, since such plans are more liberal than the present "H.R. 10" plans. Prior to the advent of the incorporated professional, such benefits were available only to employees of a "regular" corporation. Other signficant benefits available to P.A.'s are limited liability for the professional activities of a shareholder's associates and the facility for transfer of interests without disruption of the operation of the firm.

The uncertainly surrounding professional associations has been largely resolved by the Commissioner's decision to recognize firms similar to those in *O'Neill* and *Kurzner*. Ultimately, the issue will probably be settled by Congress in the form of official recognition of the incorporated professional. However, even if a particular case were decided adversely to the taxpayers, proper planning can greatly soften the blow. Probably only the sole practitioner remains vulnerable to the extent that it would be ill-advised for him to incorporate.[164]

Legal practice lends itself well to operation under Subchapter S because the principal feature of the Subchapter S election – the concept of undistributed taxable income – does not interfere with the business of the practice. The P.A. can easily maintain UTI at zero because its income is largely cash. The opportunity to pass capital gains through to the shareholders provides an additional reason to make the election, although the actual incidence of such benefits is probably not as frequent as in other businesses. These benefits must be weighted against the new limits on deferred compensation plans imposed by the Tax Reform Act of 1969.

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162. CODE §453.

163. Rev. Rul. 65-292, 1965-2 CUM. BULL. 319.

164. Hobbet, *The Corporate Entity: When Will It Be Recognized for Federal Tax Purposes?*, 30 J. TAXATION 74 (1969).