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Professional Corporations: Their Development and PresentStatus with Respect to the Practice of Medicine

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PROFESSIONAL CORPORATIONS: THEIR DEVELOPMENT AND PRESENT STATUS WITH RESPECT TO THE PRACTICE OF MEDICINE

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To say that the issue of the adoption by physicians of the corporate form for practicing medicine has been a controversial one would be to understate the obvious. Since 1961 more than 150 articles on the topic have appeared in legal periodicals alone, and when one adds on the number of books and articles that have appeared in medical literature and the literature of other concerned groups, the total is staggering.

Traditionally, the longstanding and universal bar to the corporate practice of medicine were state laws prohibiting the adoption of the corporate form. These laws were based on a fear that the corporate attribute of limited liability would cause deterioration in both the physician-patient relationship and the quality of service rendered by the physician.[1] However, as the practice of medicine became more sophisticated, demanding, and specialized, the benefits of the corporate form became more obvious. As more and more physicians formed de facto corporations to take advantage of these benefits, professional societies discovered that the ethical requirements of the physician-patient relationship could be maintained despite the use of the corporate form.[2]

As will be discussed later in this article, there are many benefits to be derived from adoption of the corporate form, not all of them related to favorable income tax treatment. However, since the greatest obstacles in the way of those who sought to take advantage of the corporate form were presented by the Internal Revenue Service (IRS), the fight to be allowed to adopt and to benefit from the corporate form is best understood when considered in light of the twenty-five years of litigation involving the refusal of the IRS to permit professionals to gain corporate tax treatment.

FORMS OF BUSINESS ORGANIZATIONS

Analysis

A physician in private practice has basically three forms of doing business available to him. He may form a sole proprietorship, a partnership, or

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1. *See* State *ex rel.* Green v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962); Wilcox, *Hospitals and the Corporate Practice of Medicine*, 45 CORNELL L.Q. 432 (1960).

2. In 1958 the American Medical Association held the corporate practice of medicine to be ethical as long as it did not involve lay control of the practice. AMERICAN MEDICAL ASSOCIATION, ARTICLES OF ASSOCIATION FOR UNINCORPORATED ASSOCIATIONS iv (1958). By 1965 a "reasonable estimate" of the number of medical corporations and associations put the figure at "at least 3,000." *See* Eaton & Maycock, *Final Professional Corporation Regulations Are an Improvement—But Not Much*, 22 J. TAXATION 208 (1965).

a corporation. While the sole proprietorship and partnership are essentially equal, they are considerably different from the corporation. Corporations, unlike partnerships, do not dissolve at the termination, legal disability, or death of a shareholder or officer. A shareholder, unlike a partner, is not personally liable for the torts of his fellow shareholders, nor is he liable for the debts of the enterprise itself. A shareholder's interest in the enterprise, unlike that of a partner, is readily transferable without negatively affecting the enterprise either legally or operatively.[3] Finally, there are distinct tax benefits available to the corporation and its owner-shareholders that are not available to partnerships or proprietorships.

Under the Internal Revenue Code corporations and their shareholders are treated as separate entities for tax purposes, whereas partnerships and their owners are not. A corporation is taxed only on the net income it receives, and its shareholders are taxed only on the income they actually receive from the corporation in the form of dividends or salaries.[4] Since partnerships and their partners are not treated as separate entities, each partner is taxed on his share of the business income *whether or not* this income is actually distributed to him.[5] Moreover, when one considers that a partnership's income is taxed at the progressive personal income tax rate,[6] while a corporation's income is taxed at a rate of 22 per cent of the first 25,000 dollars of taxable income and 48 per cent of its taxable income in excess of 25,000 dollars,[7] one advantage of corporate tax status becomes obvious.

Unlike a physician who is an owner of a partnership, the physician who is an employee of a corporation pays the progressive personal tax rate only on that portion of his enterprise's income that he receives personally in the form of salary or dividends,[8] and not on that portion of its income that an enterprise retains. Thus, the physician whose earnings place him in a high personal income tax bracket has several advantages as a corporate employee, which he would not have as an owner of the partnership.[9]

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3. The differences presented here between partnerships and corporations are those that exist between the "classic" or "academic" partnership and corporation. Many medical corporations and associations have and continue to deviate from the classic model in various ways, but for the purposes of this analysis the differences between these two forms of doing business, though simplified, are correct.

4. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§1.02, .05 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; J. MERTENS, LAW OF FEDERAL INCOME TAXATION §38.05 (rev. 1967).

5. INT. REV. CODE OF 1954, §§701, 702, 706 [hereinafter cited as CODE]; BITTKER & EUSTICE, *supra* note 4, §1.07.

6. CODE §703 (a); BITTKER & EUSTICE, *supra* note 4, §1.02.

7. CODE §§11 (b) (2), (c) (3), (d).

8. In addition, CODE §116 provides for a $100 exemption from gross income for dividends received. This article concerns the use of subchapter C tax status. For a discussion of subchapter S tax status and the professional corporation, *see* Note, *Florida Professional Associations and Subchapter S*, 22 U. FLA. L. REV. 609 (1970).

9. *See* Comment, *Taxation of Professional Service Organizations*: Morrisey *to* Empey, 29 U. PITT. L. REV. 211, 212 (1967).

Corporations and their owner-employees also have advantages that partners and proprietors do not enjoy with respect to medical, life, and accident and health insurance plans for the corporation's employees. Premium payments for these kinds of coverage can be deducted from the corporation's gross income and the payments are not included in the gross income of the employees.[10] Moreover, a 5,000 dollar death benefit exclusion is available to a beneficiary upon the death of a corporate employee.[11]

Perhaps the greatest advantages of the corporate form, however, are the benefits that an owner-employee can receive from pension, profit-sharing, stock bonus, and annuity plans. It is the denial of these advantages to those who operate in the partnership form that has probably supplied the prime motivation to physicians to achieve corporate tax status.[12] Under a plan that qualifies under section 401 of the Code, a corporation can deduct from its gross income payments that it makes into the plan,[13] and any benefits an employee receives from the plan are not taxed until actually realized.[14] Thus, an employee can delay the benefits and taxes until he retires—when the benefits will probably be taxed at a much lower rate than they would

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10. CODE §106 permits an employee to exclude his employer's premium payments for medical, surgical, hospitalization, and dismemberment insurance from his gross income, while Treas. Reg. §1.162-10 (1958) permits the employer to deduct the amounts paid from his gross income.

CODE §79 (a) (1) stipulates that an employee can exclude from his gross income the cost of premium payments for group term life insurance made by his employer to the extent of $50,000 in coverage, and the cost of these payments can be deducted as an ordinary and necessary business expense by the employer. CODE §162 (a); Rev. Rul. 56-400, 1956-2 CUM. BULL. 116. However, this deduction is not allowed if the corporation is named as a beneficiary under the policy. CODE §264 (a) (1).

CODE §105 (d) allows an employee to exclude from his gross income the amount equal to the premium payments paid by his employer for health and accident plans, while Treas. Reg. §1.162-10) (a) (1958) permits the employer to deduct this amount from his gross income.

Moreover, CODE §105 (d) also allows a corporate employee, who has become ill or injured, to exclude from his gross income wages or payments made in lieu of wages up to a limit of $100 per week. (The exclusion and its effective date vary according to conditions specified in CODE §105 (d).)

11. CODE §§101 (b) (1), (b) (2) (A). This benefit is specifically denied to self-employed individuals. CODE §101 (b) (3).

12. Comment, *supra* note 9, at 213.

13. CODE §404 (a) (3) (A) allows a corporation to deduct contributions to qualified stock bonus and profit-sharing trusts from its gross income up to a limit of 15% of an employee's annual salary, and if one or more trusts, or one or more trusts and an annuity plan (as described in §§404 (a) (1), (2), (3)) are used in an integrated plan, §404 (a) (7) allows a deduction equal to 25% of an employee's annual salary. Moreover, there is no dollar limitation for either type of plan nor, under §401 (a), will the earned or accumulated earnings of a pension trust organized as a part of such a plan be subject to taxation.

14. CODE §402 (a) (1); Treas. Reg. §1.402 (a)-1 (a) (1) (i) (1956). Moreover, if the benefits of the plan (s) are distributed in a lump sum amount in a single year because of the employee's death or retirement, the amount received by the employee or his beneficiary, which exceeds the combined employer-employee contributions to the plan (s) is taxed at capital gains rates. CODE §§402 (a) (5), 403 (a) (2) (C). *See also* Note, *Professional Corporations: Analysis Under the Tax Reform Act and Survey of State Statutes,* 58 GEO. L. J. 487, 492 nn. 34 & 35, and accompanying text (1970).

have been had he received them when he was earning a considerably larger salary.[15]

It is obvious, therefore, that the attainment of corporate status is a goal worth achieving, if only from a tax benefit point of view. However, the attainment of that status has been extremely difficult because:[16]

> [t]he entire course of action followed by the Internal Revenue Service since the early 1950's may be described as a deliberate and persistent program designed to discourage professional men from exercising their privilege of practicing through corporate entities, a privilege heretofore clearly granted to them by the courts . . . and unequivocably authorized in most states by special statute.

Having discussed the benefits of that privilege, this article will now deal with the pertinent cases and consider the current situation with respect to the ability of physicians to exercise that privilege.

THE PROFESSIONAL CORPORATION

Background

It is somewhat ironic that the case, which would ultimately come to be the standard waived by the proponents of the professional corporations in their battles with the IRS, was a case the taxpayers lost. This case, *Morrissey v. Commissioner*,[17] involved a business trust that had been formed for development of land along with the attendant powers to purchase, operate, and sell properties. At the time the trust was formed it was not as beneficial to be taxed at corporate rates as is now the case. Therefore, the trustees disputed their being taxed as an association[18] rather than as a trust. In finding for the Government, the Supreme Court held that if the characteristics of the enterprise closely resembled those of a corporation, the enterprise was to be taxed as a corporation.[19] The Court went on to establish guidelines on which to base a resemblance test and listed: (1) centralization of management; (2) continuity of life; (3) transferability of interests; (4) limited

15. Also, under CODE §151 (c) (1) a retired employee receives an additional exemption of $700 upon reaching age 65, thereby reducing the tax on plan benefits even further.

16. Sparber & Wolper, *The Current Status of Professional Corporations and Associations*, 19 J. AM. SOC. C.L.U. 197, 201-02 (1965).

17. 296 U.S. 344 (1935).

18. The Code defines "partnership" and "corporation" as follows: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other incorporated 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." CODE §7701 (a) (2). "The term 'corporation' includes associations, joint-stock companies, and insurance companies." CODE §7701 (a) (3). Therefore, to be classified as an association means to receive corporate tax treatment under the Code.

19. 296 U.S. at 357.

personal liability; (5) associates; and (6) an objective to carry on business for profit, as the corporate characteristics on which to base the resemblance test.[20]

However, in three companion cases to *Morrissey,* the Court made it clear that not all the criteria need be satisfied for the enterprise to be taxed as an association. *Swanson v. Commissioner*[21] and *Helvering v. Coleman-Gilbert Associates*[22] both involved business trusts but, unlike the trust in *Morrissey,* the beneficial owners only slightly outnumbered the trustees, so that the centralization of management criterion was not satisfied. The Court, however, not wishing the subject to "be enveloped in a cloud of uncertainty . . . simply by reason of formal variations in mere procedural details,"[23] held that "the parties [had] secured the centralized management of their undertaking through designated representatives,"[24] and agreed with the Government that the two trusts should be taxed as associations. These two cases and the somewhat later case of *Bert v. Helvering,*[25] in which, once again, not all of the *Morrissey* criteria were satisfied, developed the doctrine that when one seeks to identify or classify an enterprise for income tax purposes "the features of similarity [between the enterprise in question and a corporation] should be compared and the marks of dissimilarity contrasted. The resemblances should be balanced. It should be determined by that test the one to which the enterprise is predominantly akin in the method, mode, and form of procedure in the conduct of its business."[26]

Another device raised by taxpayers to prevent their enterprises from being taxed as corporations was summarily removed by the decision in *Pelton v. Commissioner.*[27] *Pelton* held that as long as an enterprise satisfied enough of the *Morrissey* criteria to be taxed as a corporation for federal income tax purposes, it could not prevent being so taxed simply because it was not a corporation according to the law of the state in which it was organized.[28] Thus, as of 1936, the actual structure and operating procedures of an enterprise, not its title, alleged function, or pertinent state statutes, were the controlling factors in the determination of its tax status. The unwary or careless businessman, professional or nonprofessional, could be subject to

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20. *Id.* at 359. Since characteristics (5) and (6) are generally present in all business enterprises, characteristics (1) through (4) are the ones usually referred to as the *Morrissey* criteria.

21. 296 U.S. 362 (1935).

22. 296 U.S. 369 (1935).

23. *Id.* at 373.

24. *Id.*

25. 92 F.2d 491 (D.C. Cir. 1937).

26. *Id.* at 495.

27. 82 F.2d 473 (7th Cir. 1936).

28. As will be seen in the discussion of the cases that followed and relied upon *Pelton,* the courts' reasoning and disposition of this particular issue, namely that an enterprise could be taxed as a corporation even though not a corporation under state law, has remained consistent. It has been the Government that has continually changed its argument and objectives depending upon the state of the law. An understanding of this dichotomy is essential to an appreciation of the development of the professional corporation.

the then unfavorable corporate tax treatment if he unknowingly satisfied the *Morrissey* requirements, irrespective of the enterprise's classification under state law.

Shortly thereafter some major changes were made in the Code that completely reversed the positions of the IRS and taxpayers with respect to professional corporations. The Revenue Acts of 1938 and 1942 made corporate tax status considerably *more* attractive than individual tax status with the introduction of the progressive tax[29] and, thereby, put the IRS in the novel position of having to argue that business enterprises be taxed as partnerships, while the taxpayer could take advantage of the principles of the *Morrissey, Pelton,* and *Bert* cases. Relying on that doctrine the taxpayers scored their first major victory in 1954 in the famous case of *United States v. Kintner.*[30]

The Kintner Regulations

The case arose in Montana where Dr. Arthur Kintner and several other doctors had formed an unincorporated association to practice medicine. The articles of the association stipulated that only duly licensed physicians were eligible for membership; that the beneficial interests, which members held in the association, were not assignable; that the death or retirement of a member would not terminate the association; and that a five member executive committee and officers chosen by them were to manage the business of the association. The *Kintner* court, in affirming the trial court, held that the characteristics of the association satisfied the *Morrissey* criteria. The court, relying on *Pelton* to dismiss the Government's main contention that the association could not be considered a corporation because Montana law prohibited a corporation from practicing medicine, cited the Government's own *Pelton*-based regulations and held that a determination of the nature of associations that was based on state law would destroy the essential uniformity of the federal tax system.[31]

The Government's response to its setback in *Kintner* was the issuance of what have come to be known as the "Kintner Regulations."[32] These regulations used a two-pronged approach to eradicate professional corporations. First, they dictated certain criteria that had to be satisfied by an enterprise in order for it to be classified as a corporation. Second, though conceding that federal law stipulated the tax consequences of the legal re-

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29. *See* Revenue Act of 1938, ch. 289, §165 (a), 52 Stat. 518. *See also* Int. Rev. Code of 1938, ch. 1, §12 (b), 53 Stat. 5-6, *as amended,* Revenue Act of 1942, ch. 619, 56 Stat. 802-03.

30. 216 F.2d 418 (9th Cir. 1954).

31. *Id.* at 423-24.

32. Treas. Reg. §§301.7701-1 to -11 (1960). The initial reaction of the IRS to *Kintner* had been that it would not follow the decision. *See* Rev. Rul. 56-23, 1956-1 CUM. BULL. 598. Later, it announced a change in its position with a redefinition of the classification of associations for corporate tax purposes to be forthcoming. *See* Rev. Rul. 57-546, 1957-2 CUM. BULL. 886. It then proposed new regulations in 1959, 24 Fed. Reg. 10450 (1959), and the final regulations were promulgated during the following year.

lationships between the participants, the regulations emphasized that the determination of the nature and quality of those relationships was a matter of state law, and that state law could vitiate an agreement giving the enterprise corporate characteristics.[33] The regulations generally conformed to the *Morrissey* guidelines with respect to the basic criteria,[34] but differed sharply from both that case and the ones that followed it in that the regulations assigned an arbitrary meaning to each criterion. The regulations also provided examples of the requirements of the criteria, which were worded so as to preclude corporate status for enterprises seeking classification as "associations."[35] Further, in direct contradiction of the *Morrissey-Pelton* "preponderance of criteria" test, the regulations stipulated that each criterion was to be given equal weight in determining the nature of the enterprise.[36]

The regulations, however, applied only to "associations"[37] and, under pressure from professionals and others, several states enacted laws conferring the title of "professional corporation" upon enterprises apparently under the belief that a change in labels would qualify the enterprises for corporate tax treatment.[38] This tactic was at least temporarily successful, since the confusion caused by the questionable applicability of the Kintner Regulations to "professional corporations" forced the IRS to declare a period of quasi-amnesty from 1961 through 1965. During this time the IRS agreed not to challenge a professional corporation that filed a valid corporate income tax return.[39]

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33. *See* Note, *Can Professionals Incorporate for Tax Purposes?*, 33 ALBANY L. REV. 311, 317 (1969); Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776, 779 (1962). The overwhelming effect of this emphasis on state law can be fully appreciated only when one considers that at the time the Kintner Regulations were promulgated nearly every state limited professions to the partnership form of practice—either under the Uniform Partnership Act or similar legislation. In a partnership, liability is not limited and the free transferability of interests and centralization of management is not allowed. Therefore, if state law was to be determinative and no agreements between the parties to an enterprise, as in *Morrissey* and *Kintner*, could be considered to alter that fact, it would be impossible for any professional group to gain corporate status.

34. *E.g.*, Treas. Reg. §301.7701-2 (1960) listed the major characteristics of a corporation as: (1) associates; (2) an objective to carry on business; (3) continuity of life; (4) centralization of management; (5) limited liability; and (6) free transferability of interests.

35. *See, e.g.*, Treas. Reg. §301.7701-2 (c) (1960).

36. Treas. Reg. §301.7701-2 (a) (3) (1960) stated: "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered." *See also* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 693 (1965).

37. *See* Note, *supra* note 14, at 487, 489; Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776, 779 (1962).

38. By 1965, 32 states had enacted statutes that, in effect, either conferred the title of corporation on existing organizations or allowed the organizations to acquire what was hoped to be enough corporate characteristics to satisfy the new regulations. *See* Note, *Can Professionals Incorporate for Tax Purposes?*, 33 ALBANY L. REV. 311, 321 nn. 55-58 and accompanying text (1969).

39. Rev. Proc. 65-27, 1965-2 CUM. BULL. 1017, 1019. However, it should be pointed

Faced with a flood of new enterprises formed in compliance with the new state professional corporation and association statutes, the IRS encated amendments to the Kintner Regulations in 1965.[40] In these amendments the IRS first reversed itself by stripping state laws of any importance in the determination of the nature and quality of an enterprise for federal tax purposes,[41] and then blatantly discriminated against professional corporations and associations by creating a completely new classification of enterprise.[42] Business organizations, which formerly only had to *resemble* a corporation in order for the organization to receive corporate tax treatment, now had to exhibit characteristics *identical* to those outlined in the regulations in order to be classified as a corporation for federal tax purposes.

The Courts and the Kintner Regulations

Thus, if there had been any doubt before, the battle lines were now clearly drawn. The IRS was out to "get" professionals who sought the benefits of corporate tax treatment.[43] However, the discriminatory nature of the regulations was so obvious that IRS suffered several quick and resounding defeats in the courts. Finally, on August 8, 1969, the IRS announced its acquiescence in those decisions and accorded corporate tax status to professional corporations.[44]

The collective effect of these decisions was the invalidation of the 1965 amendments on the grounds of unwarranted discrimination, and the re-

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out that this declaration of amnesty came only after many attempts by the IRS to challenge professionals attempting to make use of these new state laws. A resounding defeat in the only case to come to trial as a result of these challenges forced the IRS to adopt this position. In Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964), an association of doctors operating a clinic in Florida was held to be taxable as a corporation despite the fact that Florida law did not, at that time, allow corporations to practice medicine.

40. Treas. Reg. §301.7701, T.D. 6797, 1965-1 CUM. BULL. 553.

41. Treas. Reg. §301.7701-1 (c) (1965) stipulated, in part: "[T]he labels applied by local law to organizations, which may not or hereafter be authorized by local law, are in and of themselves of no importance in the classification of such organizations for the purposes of taxation under the Internal Revenue Code. Thus, a professional service organization, formed under the law of a state authorizing the formation by one or more persons of a so-called professional service corporation, would not be classified for purposes of taxation as a 'corporation' merely because the organization was so labeled under local law."

42. Treas. Reg. §301.7701-2 (h) (1965) created the classification of "professional service organization." These organizations, unlike other business organizations, which were classified according to their resemblance to the criteria in §§301.7701 to 301.7701-2 (g), were to be classified as corporations only if their characteristics were identical to those in §§301.7701-1 to 301.7701-2 (g). *See Internal Revenue — 1965 Treasury Regulations — Discrimination Against Professional Corporations*, 20 CASE W. RES. L. REV. 260, 262 (1968).

43. *See* Eaton, *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1, 33 (1967). *See also* Comment, *supra* note 9, at 211, 222, 224. The author also discusses the deletion of the 1960 Regulations, §301.7701-2, example (g), which had postulated a hypothetical professional association that had guaranteed corporate tax status and that had been the model used by the states in developing their pre-1965 professional corporation or association laws. *Id.* at 224.

44. T.I.R. No. 1019, 7 CCH 1969 STAND. FED. TAX REP. ¶6867, at 71,625 (Aug. 8, 1969).

establishment of the *Morrissey* resemblance test as the main standard for determining eligibility for corporate tax treatment. The differing rationales, assumptions, and arguments, which combined to produce this effect, when considered singularly were not necessarily dispositive of the total issue involved. Taken collectively, however, their attack upon the amendments was so thorough as to constitute total victory for the taxpayer.

The first case, *Empey v. United States*,[45] arose in Colorado and concerned a professional company of lawyers, incorporated under Colorado law to engage in the practice of law.[46] The lawyers sought to be taxed as a corporation and, therefore, squarely presented the question of whether professional men could organize in such a way as to be taxed as a corporation under the Kintner Regulations and their 1965 amendments. The IRS argued that the peculiar nature of the doctor-patient and lawyer-client relationship made it impossible for professionals, by organizing or incorporating, to achieve corporate status for federal tax purposes. The court dismissed this argument upon the observation that Congress' definition of a partnership in the Code referred only to unincorporated organizations. The court also found no case law or congressional action or intention to expand that definition and that therefore, the Kintner Regulations "constitute[d] the exercise of a non-delegable legislative function and [were] invalid and unenforceable."[47] The court further asserted that even if the Kintner Regulations were assumed *arguendo* to be valid, the company of lawyers more nearly resembled a corporation than a partnership and was, therefore, deserving of corporate tax treatment.[48] The court did not, however, base this determination on an examination of the 1965 amendments. Rather, it evaluated the company in light of the *Morrissey* resemblance test. The court, therefore, not only failed to consider the crux of the 1965 amendments but also placed considerable emphasis on state law determination of corporate classification, an argument quite inconsistant with both *Pelson* and *Kintner*.[49]

The next case[50] arose in Ohio and involved a medical organization of fourteen doctors, which provided radiological services to hospitals and individual patients. The organization was authorized as a professional association under Ohio law.[51] Although the general question was whether the organization was taxable as a corporation for federal income tax purposes, the specific question involved the validity of Treasury Regulation 301.7701-2(h)—the "professional service organization" subsection. In finding for the taxpayer, the court first examined the Ohio Professional Association Law

45. 272 F. Supp. 851 (D.C. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1969).

46. Rule 265. Professional Service Corporations and Joint Stock Companies, COLO. REV. STAT. (1970).

47. 272 F. SUPP. 851, 853 (1967).

48. *Id.* at 854.

49. *Id.*

50. O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969).

51. OHIO REV. CODE ANN. §§1785.01-.08 (Page 1964).

and found the medical organization to be a corporation under Ohio law.[52] It then proceeded to examine subsection 2(h) of the Regulations. After noting the more stringent requirements this subsection imposed on professional service organizations (compared with the general requirements that subsections (a-g) presented to all other organizations desirous of corporate tax treatment), the court found no basis for this discriminatory treatment in either case law, congressional action, or the actual organization of a professional service organization. Therefore, the court held the subsection to be invalid and ordered the medical organization to be taxed as a corporation.[53]

Two interesting aspects of this decision, which may have considerable long-term effects, were the court's reliance on the "business purpose" doctrine and its use of principles espoused in *Foreman v. United States*.[54] The "business purpose" doctrine was the product of the decision in *Gregory v. Helvering*[55] in which the Supreme Court held that, even though a taxpayer had the "legal right . . . to decrease the amount of what otherwise would be his taxes, or altogether avoid them" by legal means,[56] if the taxpayer, in reorganizing his business organization, was motivated *solely* by the desire to avoid taxes rather than by a business purpose, he will not be permitted to succeed in avoiding those taxes.[57] Neither *Gregory* nor its doctrine was cited in either *Kintner* or *Empey* but was obviously heavily relied upon by the plaintiff in *O'Neill*. In *O'Neill* the plaintiff alleged that his principal purpose in changing the form of the medical organization from a partnership to a corporation "was the non-tax 'business purpose' of controlling a sizeable and unwieldy organization."[58] The court found that this was the principal purpose for the reorganization and as will be discussed subsequently, also noted that this finding *could* be of significant importance to those professionals who incorporate in the future.[59]

The *Foreman* case was cited by the court in *O'Neill* to underscore both the discriminatory nature of subsection 2(h) and the inconsistency of the reasoning of the IRS in behalf of that discrimination. The importance of *O'Neill*, however, lies in the fact that it is the only instance in which a court, other than the court in *Foreman*, not only noted that there were "not . . . any factual or legal characteristics which would justify different tax treatment of closely held professional service organizations, on the one hand, and closely held non-professional service organizations, on the other hand,"[60] but also pointed out the patently discriminatory nature of the enforcement by the IRS of its regulations.[61] The court thereby recognized that only a

52. 281 F. Supp. at 362.
53. *Id.* at 364-65.
54. 232 F. Supp. 134 (S.D. Fla. 1964); *see* note 39 *supra*.
55. 293 U.S. 465 (1935).
56. *Id.* at 469.
57. *Id.* at 469-70. *See also* BITTKER & EUSTICE, *supra* note 4, §§1.05, 13.02.
58. 281 F. Supp. at 361.
59. *Id.*
60. *Id.* at 364.
61. *Id.*

select group of those who sought to achieve corporate tax status were the objects of the wrath of the IRS.

The decisions subsequent to *O'Neill* have utilized the *Empey* and *O'Neill* principles and have unanimously held medical groups, which were operating as corporations under state law, to be taxable as corporations for federal tax purposes. In *Kurzner v. United States*,[62] *Holder v. United States*,[63] *Wallace v. United States*,[64] *Cochran v. United States*,[65] *Van Epps v. United States*,[66] and *Smith v. United States*[67] the courts consistently held that those enterprises that were formed under and complied with their respective states' professional incorporation or association statutes were to be considered corporations for federal tax purposes. This unbroken string of decisions, coupled with the acquiescence in those decisions and the granting of corporate tax status to professional corporations by the IRS on August 8, 1969,[68] constitute a decisive and seemingly total victory for the professional taxpayer. Whether the effects of this victory will be permanent remains to be seen.[69]

State Legislation

At the present time forty-nine states have passed legislation allowing organizations of physicians to adopt the corporate form for practicing medi-

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62. 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969).
63. 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd*, 412 F.2d 1189 (5th Cir. 1969).
64. 294 F. Supp. 1225 (E.D. Ark. 1968).
65. 299 F. Supp. 1113 (D. Ariz. 1969).
66. 301 F. Supp. 256 (D. Ariz. 1969).
67. 301 F. Supp. 1016 (S.D. Fla. 1969).
68. *See* note 44 *supra*. *See also* N.Y. Times, Oct. 26, 1969, at 1, col. 5 (city ed.).
69. It cannot be assumed that physicians can now act in a haphazard manner on the question of incorporation. The question of the one-man professional corporation is still unresolved. *See* note 72 *infra*. The IRS has also shown it will not confer corporate status on a professional corporation that does not conduct itself as a corporation. In Jerome J. Roubik, 53 T.C. 365 (1969), the Tax Court found that a Wisconsin professional service association of radiologists, which did not earn any income from its members' services, which maintained substantially separate financial records for each physician, and which varied only slightly in structure and form from the partnership that preceded it, was not deserving of corporate status or treatment. *See also* Comment, *Taxes — Professional Service Corporation*, 4 SUFF. L. REV. 958 (1970).
70. Wyoming is the only state without legislation in this area. Thirty-nine states permit the formation of professional corporations and ten states authorize professional associations (for tax purposes this distinction is immaterial; *see* Code §7701 (a) (3)). However, the types and number of occupational groups affected differ considerably. Twenty-nine states permit any licensed individuals to form a professional corporation, thereby bringing many non-medical groups within the purview of the legislation. These states are Alabama, Alaska, Arizona, Arkansas, California, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Kentucky, Maine, Maryland, Michigan, Mississippi, Nebraska, Nevada, New Jersey, New Mexico, North Dakota, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Vermont, Washington, and Wisconsin. *See, e.g.*, MICH. COMP. LAWS ANN. §450.224 (1967): "An individual or group of individuals duly licensed or otherwise legally authorized to render the same professional services in this state may organize and become a shareholder or shareholders of a professional corporation." Fifteen other states specifically designate those professionals who may

cine.[70] Although there is general uniformity among these statutes, there are certain significant variations between the laws of certain states that should be appreciated by the physician who considers forming a professional corporation.

Perspective Analysis

In order to facilitate an examination of the various laws, they will be considered from four perspectives: (1) personnel, (2) liability, (3) allowable business activity, and (4) transferability of interest.

Personnel. In all forty-nine states with legislation dealing with professional corporations, only those individuals who are licensed to practice medicine in a given state may adopt the corporate form within that state.[71] The minimum number of physicians required to form the professional corporation ranges from one to three, with one-man corporations being permitted in a majority of the states.[72] All states require that all shareholders be licensed physicians,[73] and three states add the additional requirement that a shareholder must be licensed to practice *and* actively engaged as an employee of his corporation.[74]

There is considerable deviation among the states on the question of corporate management. Although ten states make no reference to manage-

form professional corporations. These states are Connecticut, Hawaii, Iowa, Kansas, Massachusetts, Missouri, Montana, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Rhode Island, Utah, and Virginia. *See, e.g.*, MONT. REV. CODES ANN. §15-2103(1) (1967): "The term 'professional service' means any professional service rendered by attorneys, certified public accountants, public accountants, chiropractors, dentists, osteopaths, doctors of medicine, chiropodists, architects, veterinarians, optometrists, nurses, pharmacists, physical therapists and professional engineers." Finally, five states, Colorado, Connecticut, Minnesota, South Dakota, and West Virginia have enacted legislation that allows only the members of a small number of selected professions to form professional corporations. *See, e.g.*, MINN. STAT. ANN. §§319.01-.961 (1969), which allows only physicians, attorneys, dentists, chiropractors, and optometrists to form professional corporations.

71. *See, e.g.*, LA. REV. STAT. §12:902 (1969): "One or more natural persons, of full age and duly licensed to practice medicine in this state, may form a corporation under Chapter I of this Title for the purpose of practicing medicine."

72. Thirty-four states require only one incorporator. Eight states require two, and four require at least three. Three states, Colorado, North Carolina, and Rhode Island have no requirement. Although thirty-four states permit one-man corporations, there is considerable doubt as to whether this type of enterprise will qualify as a corporation for income tax purposes. The reason for this is the fact that the IRS reserved the right to tax as partnerships those enterprises reflecting "special circumstances" not present in the *O'Neill* and *Kurzner* cases. *See* text accompanying notes 58-67 *supra.* Since neither case involved a one-man professional corporation, the IRS is not bound to award corporate status to this type of enterprise. However, since a two-man enterprise was approved in *Kurzner*, two would appear to be a sufficient number of professionals.

73. *See, e.g.*, ME. REV. STAT. ANN. tit. 13, §710 (1969): "No corporation organized under this chapter may issue any of its capital stock to anyone other than an individual who is duly licensed or otherwise legally authorized to render the same specific professional services as those for which the corporation was incorporated."

74. Colorado, Nevada, and Rhode Island. *See, e.g.*, NEV. REV. STAT. §89.020 (1970).

ment at all,[75] twenty-one states require that a person be a licensed physician in order to be an officer or director of a professional corporation,[76] and eight states add the additional requirement that officers and directors must also be shareholders.[77] Only nine states specifically allow nonprofessionals to be officers or directors,[78] but this allowance runs counter to the American Medical Association's *Principles of Medical Ethics,* and, thereby, presents a conflict that few physicians would appear willing to entertain.[79] Finally, although a small minority of states do prohibit such affiliation,[80] the vast majority of states allow physicians to serve concurrently as directors of more than one professional corporation.

Liability. Probably the most controversial nontax issue concerning professional corporations and associations has been the quality of both the physician-patient relationship and the medical care delivered, and the degree to which they would be affected or altered by the adoption of the corporate form.[81] Because the concern over these matters has been so great, the majority of states have refused to change the existing law with respect to either the tort or contract liability of corporate employee-physicians. More than half the states deal with tort liability by stating that the "existing law" on point is not altered or modified,[82] and an even greater number of states adopt this approach with respect to contract liability.[83] The result of this legisla-

75. Idaho, Maryland, Michigan, Mississippi, Montana, North Dakota, Ohio, Pennsylvania, Tennessee, and West Virginia.

76. Arizona, Arkansas, Connecticut, Florida, Illinois, Indiana, Iowa, Kentucky, Massachusetts, Minnesota, Nebraska, New Hampshire, New Mexico, Oklahoma, South Dakota, Texas, Utah, Vermont, Virginia, Washington, and Wisconsin. *See, e.g.,* MASS. GEN. LAWS ANN. ch. 156A, §8 (1970).

77. Alaska, Kansas, Louisiana, Maine, Missouri, Nevada, Oregon, and Rhode Island. New York requires that a director or officer be either a shareholder or an employee of his corporation.

78. Alabama, California, Colorado, Delaware, Georgia, Hawaii, New Jersey, North Carolina, and South Carolina. *See, e.g.,* ALA. CODE tit. 46, §336 (Supp. 1970).

79. Under the AMA's PRINCIPLES, as interpreted in AMA, OPINIONS AND REPORTS OF THE JUDICIAL COUNCIL §6, Opinions 13-14 (1969), the ownership of a professional medical corporation must remain "directly and solely under the control of licensed physicians." However, in the 1963 case of State Bd. of Accountancy v. Eber, 149 So. 2d 81 (1st D.C.A. Fla. 1963), it was held that a state licensing board could not prevent a person from practicing as a corporation simply on the grounds that such a form of practice violated the profession's code of ethics, when state law specifically permitted this form of practice.

80. Alaska, Massachusetts, Missouri, Nebraska, North Dakota, Rhode Island, and Vermont.

81. *See* Willcox, *Hospitals and the Corporate Practice of Medicine,* 45 CORNELL L.Q. 432 (1960).

82. *See, e.g.,* ALA. CODE tit. 46, §335 (Supp. 1969): "This chapter does not modify any law applicable to the relationship between a person furnishing professional services and a person receiving such service, including liability for tort arising out of such professional service." Twenty-five states have similar legislation.

83. *See, e.g.,* KAN. STAT. ANN. §17-2708 (Supp. 1971): "The general laws of the state of Kansas relating to corporations . . . except as otherwise provided herein, shall be applicable to a professional corporation organized pursuant to this chapter." Twenty-nine states deal with contract liability in this manner.

tion has resulted in considerable confusion as to the extent of the individual physician's liability. Is he liable only for his own torts, for his own plus those of the people whose work he directs or supervises, or for those of everyone in his organization? Moreover, what is the extent of the shareholder-physician's liability for the corporate debts and obligations of his organization? Is he personally liable only up to or beyond the extent of his capital investment in the organization? Some states have dealt specifically with one or more of these problems. Seventeen states hold the corporation liable for all the torts of its shareholder-employees, but hold the shareholder-employees personally liable only for those torts that they themselves or employees directly under their supervision commit.[84] The seven remaining states that have considered these problems have adopted the extreme position of holding all the corporation's shareholders personally liable for the torts of any and all members of the corporation.[85]

In the contract area, only fifteen states limit the extent of a shareholder's liability to the amount of his capital investment,[86] while four states extend full personal liability to a shareholder who has personally participated in the transaction out of which a debt or claim has arisen.[87] Only one state has adopted the extreme position of imposing joint liability on all shareholders for the contractual obligations of the corporation.[88]

No state has altered the privileged or fiduciary relationship between a physician and his patient through its professional corporation-association legislation.[89] However, the handling of the liability issue can generally be said to put the shareholder of a professional corporation in a much more precarious position than that occupied by the shareholder of an ordinary business corporation.

Allowable Business Activity. The nature and extent of the business activity in which a professional medical corporation may engage is open to question. Although four states allow professional corporations to engage in business unrelated to the professional service that they were organized to render (as long as they do not engage in another licensed profession),[90] all other states prohibit a professional corporation from engaging in any other busi-

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84. Alaska, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Nebraska, New Jersey, New York, North Dakota, Texas, and Washington. *See, e.g.*, CONN. GEN. STAT. ANN. §33-182e (Supp. 1971); FLA. STAT. §621.07 (1969).

85. Arizona, Colorado, Maine, Montana, Oregon, Pennsylvania, and Wisconsin. *See, e.g.*, ME. REV. STAT. ANN. tit. 13, §708 (Supp. 1972).

86. Connecticut, Colorado, Florida, Hawaii, Idaho, Iowa, Kentucky, Louisiana, Maine, Minnesota, Montana, Nebraska, North Dakota, Oregon, and Tennessee. *See, e.g.*, CONN. GEN. STAT. ANN. §33-182e (Supp. 1971); KY. REV. STAT. ANN. §274.055 (1971).

87. Alabama, Alaska, Georgia, and South Carolina. *See, e.g.*, ALA. CODE tit. 46, §335 (Supp. 1969).

88. *See* PA. STAT. ANN. tit. 15, §12617 (1967).

89. *See, e.g.*, KY. REV. STAT. ANN. §274.055 (1969).

90. Arizona, California, Illinois, and Massachusetts. *See, e.g.*, ILL. ANN. STAT. ch. 106½, §§101, 104 (Smith-Hurd Supp. 1971).

ness activity, but do allow them to invest in stocks, bonds, mortgages, and real estate.[91] Problems arise from the fact that, while no state statute provides guidelines as to what constitutes engaging in another business as opposed to investment in another business, some states have expressly forbidden physicians to engage in certain kinds of business activity in which the American Medical Association permits them to engage.[92] In addition, while the lack of uniformity among the states on the issue of mergers between professional corporations[93] makes the creation of very large multistate medical corporations highly improbable, the possibilities of greater profits through related business activities in certain states would appear to foster a maldistribution of physicians.

Transferability of Interests. As discussed previously, all professional corporation statutes require shareholders to be licensed physicians.[94] Accordingly, every statute restricts the transfer of shares to licensed physicians, with thirteen states adding the additional requirement that any transfer must have the approval of a majority of the organization's shareholders.[95] The situation with respect to voting rights, however, is not as clear cut. Seven states permit voting rights to be transferred only to other shareholders in the same corporation,[96] while six states permit transfer to any licensed physician.[97] At the other extreme, fourteen states prohibit transfer to any-

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91. *See, e.g.,* IDAHO CODE ANN. §30-1307 (1967). Alaska, Arizona, Colorado, Indiana, Iowa, Massachusetts, Nevada, Oklahoma, Oregon, Utah, Vermont, and Washington further limit a professional corporation's activities to those activities that an individual practicing that particular profession is permitted to perform. *See, e.g.,* IND. ANN. STAT. §25-5107 (1970).

92. *See* Note, *Professional Corporations: Analysis Under the Tax Reform Act and Survey of State Statutes,* 58 GEO. L.J. 487, 517-19 (1970), in which the question of a physician's ownership of an interest in or his operation of a pharmacy, medical laboratory, nursing home, and an optical dispensary shop is discussed in light of the small number of states that prohibit such ownership and the even smaller number of cases on point.

93. Only eighteen states (Alaska, Delaware, Florida, Idaho, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, and Washington) specifically permit professional corporations to merge, but all require that the merger be made only with another professional corporation organized under that state's laws, which is empowered to render the same specific professional service. *See, e.g.,* N.M. STAT. ANN. §51-22-13 (Supp. 1969). The remaining thirty-one states do not deal with the topic of merger specifically, but rather rely on their individual licensing requirements to exclude foreign professional corporations. *See* notes 71-80 *supra.*

94. *See* notes 70-73 *supra.*

95. Alaska, Delaware, Idaho, Kansas, Maine, Michigan, Mississippi, Missouri, Montana, New Jersey, New Mexico, New York, and North Carolina. Iowa has gone even further by requiring that a transfer must be approved by "the affirmative vote or consent in writing of all the outstanding shareholders entitled to vote, or such lesser proportion as may be provided in the articles or bylaws." IOWA CODE ANN. §496C.11 (1972).

96. Alaska, California, Hawaii, Kansas, Missouri, Nevada, and Oregon. *See, e.g.,* KAN. STAT ANN. §17-2712 (Supp. 1971).

97. Arizona, Arkansas, Iowa, Minnesota, South Dakota, and Wisconsin. *See, e.g.,* ARK. STAT. ANN. §64-1714 (1966).

one,[98] while the remaining states have made no reference to the transfer of voting rights in their statutes.

Finally, although there is a considerable difference between the methods provided for determining the value of shares,[99] all professional corporation statutes give the corporation the right to redeem the shares of their deceased or disqualified shareholders from executors, administrators, or successors in interest.[100] However, the states differ markedly on the length of time that an unqualified or nonprofessional shareholder may hold the stock,[101] with some states even allowing limited voting rights to nonprofessionals during this period.[102]

CONCLUSION

As this discussion of the development of the professional medical corporation/association and the current state laws governing its existence and activities indicates, the only quality that can be consistently observed in or attributed to this kind of enterprise is inconsistency. Physicians have, at least for the moment, won the right to incorporate and to reap the benefits of corporate status. However, the ability to do so in theory is quite far removed from the ability to do so in fact. Physicians should, therefore, be well aware of the different requirements and prohibitions of state law and not think of incorporation only in light of some possible tax benefits. It is correct to say that the development of the professional corporation/association has taken place in a mix of forces overwhelmingly colored by tax considerations. There are, however, many other colors in the legal spectrum, and a consideration of all the relevant hues is critical if the correct method for making the medical expertise of a given group of doctors available to a community is to be created and maintained.

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98. Connecticut, Delaware, Florida, Idaho, Indiana, Louisiana, Maine, Maryland, Michigan, Mississippi, Montana, New Jersey, North Carolina, and Washington. *See, e.g.*, MISS. CODE ANN. §5390-48 (Supp. 1971).

99. *See* Note, *supra* note 92, at 527-29, nn. 244-257 and accompanying text. Both Iowa and New York require that the book value of the stock be considered to be its redemption value.

100. *See, e.g.*, MO. ANN. STAT. §356.100 (1966).

101. The majority of states do not set a limit on the length of time that a nonprofessional or disqualified shareholder may hold stock. Disqualified shareholders may retain stock for 90 days in Arizona, California, Hawaii, Maryland, Michigan, Minnesota, Missouri, Nevada, Oklahoma, Utah, Vermont, and Wisconsin; for 30 days in New Jersey; and for 6 months in New York.

The representative of a deceased shareholder can hold stock for 90 days in Arizona, Maryland, Minnesota, Missouri, Nevada, Oklahoma, Utah, Vermont, and Wisconsin; for 6 months in California, Hawaii, New York, and Oregon; for one year in Kentucky, New Jersey, North Carolina, and West Virginia; and for a "reasonable period" in Alabama, Delaware, Georgia, Michigan, New Hampshire, and North Dakota.

102. Delaware, Georgia, and North Dakota. *See, e.g.*, GA. CODE ANN. §84-4310 (1970).