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THE ABILITY OF PROFESSIONAL GROUP PRACTICES TO AVOID THE COVERAGE AND ANTI-DISCRIMINATION REQUIREMENTS FOR QUALIFIED PLANS

INTRODUCTION

Professionals engaged in group practices have discovered a planning device for qualified corporate retirement plans that maximizes flexibility in their retirement plans and allows circumvention of the coverage and anti-discrimination requirements for qualified plans. The structure of the plan requires the incorporation of each professional in the group pursuant to state professional corporation acts and the creation of a partnership, with each corporation becoming a general partner. The rank-and-file staff employees of the group practice are employed by the partnership instead of the professional corporations. Each professional corporation then adopts a qualified retirement plan for its sole professional employee according to his particular desires or needs.[1] The intended result is that this retirement plan will not be required to cover the rank-and-file employees of the group practice because the corporations are not their employers.[2] Since the tax incentives provided by the qualified retirement plan rules of the Internal Revenue Code are intended to encourage the formation of retirement plans that also benefit rank-and-file employees, it is not surprising that this planning device has become extremely controversial. This note will analyze the litigation and legislation spawned by such plans and will examine several problems that have not yet been resolved.

SECTION 414(c) AND THE *Garland* CASE

Congress enacted section 414(b) and 414(c) of the Internal Revenue Code as part of ERISA.[3] Section 414(b) provides that for purposes of sections 401, 408(k), 410, 411 and 415 all employees of corporations that are members of a controlled group of corporations are to be treated as employed by a single employer.[4] Section 414(c) similarly provides that for purposes of those same Code sections "all employees of trades or businesses (whether or not incorporated) which are

1. Some limitations imposed affect even single employee corporate plans. For example, I.R.C. §415(c)(1) provides that annual contributions to a qualified profit-sharing plan cannot exceed the lesser of $25,000 or 25% of the participant's compensation. The $25,000 figure, however, is adjusted annually for inflation as evidenced by Internal Revenue News Release 80-17 released January 5, 1980, which increased that limit to $36,875 for 1980. Compare the maximum deduction of $7,500 to a Keogh plan of a partnership where at least one participant is an owner-employee. I.R.C. §§401(c), 404(c).

2. The plan of the professional corporation need only consider its sole employee and not the staff employees of the partnership because §401(a), in setting forth the requirement for plan qualification, deals with the plans of an employer for the benefit of his employees. If the professional individual covered by the plan is the professional corporation's only employee, then the staff employees of the partnership will not cause the plan to be disqualified under §§401(a)(3), 410(b), and 410(a)(4) with regard to discrimination in coverage or benefits under the plan.

3. H.R. REP. No. 93-533, 93rd Cong., 2d Sess. (1974), 1974-3 C.B. 210.

4. I.R.C. §414(b).

under common control shall be treated as employed by a single employer."[5] Congress, aware of the ease with which the coverage and anti-discrimination provisions of the Code could be circumvented by mere form of organization,[6] intended that

> in applying the coverage test, as well as the anti-discrimination rules, the vesting requirements, and the limitations on contributions and benefits, employees of all corporations who are members of a "controlled group of corporations" . . . are to be treated as if they were employees of the same corporation. . . . [I]n the case of partnerships . . . all employees of such organizations are to be treated for purposes of these rules, as though they were employed by a single person.[7]

Sections 414(b) and 414(c) were aimed at eliminating the practice of segregating rank-and-file employees, with respect to whom discrimination is prohibited,[8] into a separate corporation or into a partnership whose members are professional corporations.

Common Control

The single employer treatment of section 414(c) can affect a partnership of professional corporations, but only if the trades or businesses are under common control. Section 414(c) directs the Secretary to prescribe regulations based on principles similar to the principles which apply to section 414(b). Section 414(b) applies to controlled groups of corporations and states that the existence of a controlled group is to be determined by section 1563(a).[9] Thus, the general principles for the regulations defining trades or businesses under common control for purposes of section 414(c) are ultimately to be derived from section 1563(a).

In conformity with the legislative directive, temporary regulations under section 414(c) were issued espousing the principles underlying section 1563(a) of the Code.[10] They define two or more trades or businesses under common control in terms of three categories: parent-subsidiary groups, brother-sister groups, and combined groups of trades or businesses.[11] A partnership of pro-

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5. I.R.C. §414(c).

6. "The committee, by this provision, intends to make it clear that the coverage and anti-discrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation." H.R. Rep. No. 93-807, 93rd Cong., 2d Sess. 49 (1974), 1974-3 C.B. 285 (Supp.).

7. *Id.*

8. See §401(a)(4) which prohibits discrimination in favor of officers, shareholders, or the highly compensated as to contributions or benefits provided under a qualified plan.

9. I.R.C. §1563(a) is a definitional statute that determines the members of a controlled group of corporations for purposes of imposing the §1561 limitations on certain multiple tax benefits.

10. Temp. Reg. §§11.414(c)-1 to 11.414(c)-5 were issued under T.D. 7388, 1975-2 C.B. 180, and are to remain in effect until permanent regulations are adopted. There are also proposed regulations for §414(c), but they are identical to the relevant temporary regulations and, thus, only the temporary regulations will be cited.

11. Temp. Reg. §11.414(c)-2, 44 Fed. Reg. 19,285, 56,504 (1979).

fessional corporations is most likely to be categorized as a brother-sister group of trades or businesses under common control.[12] The temporary regulations defining a brother-sister group are patterned after the definition of that term in section 1563(a)(2) and involve a two-pronged test. The first prong is the controlling interest test and the second is the effective control test.

The controlling interest test for a brother-sister group requires that five or fewer individuals own a controlling interest in each organization within such group.[13] A controlling interest in a corporation or a partnership means ownership of at least 80 percent of the stock of a corporation or 80 percent of the profits or capital interest of a partnership.[14] The theory behind the controlling interest test is that ownership of 80 percent or more of two or more organizations by five or fewer individuals could allow those individuals to operate the organizations as one economic entity.[15] In the context of section 414(c), if a partnership of professional corporations is capable of operating as one economic entity, all employees of those corporations will be treated as employed by the partnership in determining whether their pension and profit-sharing plans are qualified.

A partnership of professional corporations does not constitute a brother-sister group unless it also satisfies the effective control test. That test is met only if those same five or fewer individuals counted in the controlling interest test own more than 50 percent of each organization. Ownership interests, however, are counted only to the extent they are identical with respect to each organization in the control group.[16] For example, if an individual owns 20 percent of corporation *A* and 10 percent of partnership *B*, his identical ownership in each organization is 10 percent. As a result of the effective control test, the members of a brother-sister group will be characterized by *common* control and ownership. The rationale for this test is to insure that the definition of brother-sister groups encompasses only situations where the five or fewer in-

12. *See* Temp. Reg. §§11.414(c)-2(b), -2(d), 44 Fed. Reg. 19,285, 56,504 (1979). These regulations define parent-subsidiary group and combined group respectively, and both require a common parent organization that directly owns a controlling interest (generally 80%) in at least one of the other organizations within the group. It is not likely that a group of professionals seeking the advantage of a partnership of professional corporations in the employee benefit area would form a professional corporation that owns 80% or more of the partnership directly. Note that the attribution of ownership rules prescribed by Temp. Reg. §11.414(c)-4 are not generally applicable in determining whether the controlling interest is achieved by the common parent.

13. Temp. Reg. §11.414(c)-2(c)(1), 44 Fed. Reg. 19,285, 56,504 (1979).

14. Temp. Reg. §11.414(c)-2(b)(2), 44 Fed. Reg. 19,285, 56,504 (1979).

15. *Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. 5394 (1969) [hereinafter cited as *Hearings on Tax Reform*].

16. Temp. Reg. §§11.414(c)-2(c)(2), 44 Fed. Reg. 19,285, 56,504 (1979). Note that for purposes of applying the limitations of §415, §415(h) provides that the controlling interest test for determining §414(c)'s applicability will consist of a more than 50% test as opposed to an at least 80% test. As a result, there could be situations where the plans of two different employers would be aggregated as a §414(c) group for applying §415 limits on contributions or benefits, yet not be deemed a §414(c) group for purposes of applying the coverage provision of §401(a)(3) and §410(b) as if all employees were employed by a single employer. This substitution of 50% for 80% only applies with respect to parent-subsidiary controlled groups, however.

dividuals own their 80 percent controlling interest in a manner enabling them to operate the member organizations as one economic entity.[17]

To illustrate the definition of a brother-sister group of organizations under the temporary regulations to section 414(c), assume the following facts. Four doctors are engaged in a group medical practice in a partnership form. The three older doctors decide to form a professional corporation that will become a 75 percent general partner. The staff employees will remain employed by the partnership. The intent behind this structure is to enable the professional corporation to adopt a qualified pension or profit-sharing plan that covers only the three doctors, who are the corporation's only employees. According to the applicable temporary regulations, however, the professional corporation and the partnership constitute a brother-sister group of trades or businesses under common control.[18]

In determining whether the controlling interest test is met, the 75 percent profits interest owned by the professional corporation is attributed from the corporation to the three doctor-shareholders by an attribution rule in the temporary regulations.[19] The controlling interest test requires five or fewer individuals to own at least 80 percent of both the partnership and the professional corporation. An example in the temporary regulations indicates that the fourth doctor's 25 percent ownership interest of the partnership is added to the 75 percent interest attributed to the other three doctors so that the controlling interest test is met notwithstanding the fact that he did not own an interest in the corporation.[20] The temporary regulation defining the controlling interest test does not expressly address the issue of whether the fourth doctor must own an interest in each member of the brother-sister group before his ownership interests can be aggregated for the controlling interest test.

The second prong of the tests for a brother-sister group is the more than 50 percent effective control test. The three doctors own 100 percent of the professional corporation and indirectly own 75 percent of the partnership. Their identical ownership in each organization is 75 percent. The effective control test is satisfied, resulting in the application of section 414(c) to the brother-sister group. The professional corporation's plan would be disqualified because it did not cover the staff employees of the partnership as required by section 414(c).

Application of the Control Tests

The interpretation of exactly which individuals' interests are allowed to be aggregated under the 80 percent controlling interest test recently has come under attack in the context of section 1563(a). A regulation example under

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17. *Hearings on Tax Reform, supra* note 15.

18. There is not a parent-subsidiary relationship here, for Temp. Reg. §11.414(c)-2(b)(ii) requires a common parent organization to own directly a controlling interest in at least one organization within the controlled group. The professional corporation owns only 75% of the profits interest in the partnership, thereby falling short of the 80% required by Temp. Reg. §11.414(c)-2(b)(2)(i)(C), 44 Fed. Reg. 19,285, 56,504 (1979).

19. Temp. Reg. §11.414(c)-4(b)(4)(i), 44 Fed. Reg. 19,285, 56,504 (1979).

20. Temp. Reg. §11.414(c)-2(e), example 4, 44 Fed. Reg. 19,285, 56,504 (1979).

section 1563(a) is identical to the temporary regulation example to section 414(c) that required the fourth doctor's 25 percent interest in the partnership to be added in applying the controlling interest test.[21] It is clear that neither the section 414(c) temporary regulation defining the controlling interest test[22] nor section 1563(a)(2)(A) itself requires identical ownership in all the organizations within the controlled group prior to counting an individual's ownership interest for purposes of the controlling interest test. It's unclear, however, whether the fourth doctor's interest in the partnership should be considered for the controlling interest test where he owned no interest in the corporation.[23]

In a recent line of cases, the Tax Court has indicated that an individual's ownership interest is not to be taken into account in determining whether the 80 percent controlling interest test of section 1563(a)(2) is met unless that individual owns an interest in each member of the brother-sister controlled group.[24] As a policy basis for its position, the Tax Court reasoned that because Congress intended to reach only groups of organizations under common control, an individual must own an interest in each organization before his ownership interests can be counted toward the controlling interest test. Although the court views the identical ownership requirement of the effective control test as additional assurance that the brother-sister group categorization reaches only organizations capable of operating as one economic entity, it does not view the effective control test as precluding the necessity for a common ownership requirement in the controlling interest test.

In invalidating the example in the regulations interpreting the definition of a brother-sister controlled group, the Tax Court has also relied on what it perceives to be the thrust of the statutory language of section 1563(a)(2).[25] The relevant language defining a brother-sister controlled group states:

> five or fewer persons . . . own . . . (A) at least eighty percent . . . of each corporation, and (B) more than fifty percent . . . of each corporation, taking into account the stock ownership of *each such person* only to the extent such stock ownership is identical with respect to each such corporation.[26]

The Tax Court reasons that the words "each such person" refer to the "five or fewer persons" who constitute the ownership group for purposes of both the 80 percent controlling interest test and the 50 percent effective control test.

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21. Reg. §1.1563-1(a)(3)(ii), example 1, 44 Fed. Reg. 19,285, 56,504 (1979). *See also* Temp. Reg. §11.414(c)-2(e), example 4, 44 Fed. Reg. 19,285, 56,504 (1979).

22. Temp. Reg. §11.414(c)-2(c)(1), 44 Fed. Reg. 19,285, 56,504 (1979).

23. The theory behind the two-pronged test for a brother-sister group is to insure that the definition of such a group encompasses only those situations where five or fewer individuals own a controlling interest of each organization involved in a manner enabling them to operate the member organizations as one economic entity. *See Hearings on Tax Reform, supra* note 15.

24. *See* Allen Oil Co., 38 T.C.M. 355 (1979); Delta Metal Forming Co., 37 T.C.M. 1458 (1978); Charles Baloian Co., 68 T.C. 620 (1977); Fairwax Auto Parts, Inc., 65 T.C. 798 (1976); T.L. Hunt, Inc., 35 T.C.M. 966 (1976).

25. *See, e.g.*, Fairfax Auto Parts, Inc., 65 T.C. 798, 804 (1976).

26. I.R.C. §1563(a)(2) (emphasis added).

Thus, each person counted for purposes of the 80 percent test must have been counted for purposes of the 50 percent test. Before a person's stock ownership can be taken into account for the purpose of the 80 percent test, that person must own stock in each member of the brother-sister controlled group.[27] The court, in essence, is reversing the two-pronged tests for a brother-sister group. First, it looks to the effective control test with its identical ownership requirement, and then it considers only persons counted in that test for the purpose of applying the 80 percent controlling interest test.[28]

The definition of a brother-sister group contained in the temporary regulations to section 414(c) parallels that of section 1563(a)(2), and the policies behind both statutes are similar. Section 414(c) encompasses groups of businesses under common control and conditions a tax benefit upon the manner in which all employees of the organizations are taken into account. Section 1563(a) also encompasses groups of corporations under common control for purposes of limiting certain tax benefits available to them. Unless the policy behind section 414(c) is deemed to be of a greater magnitude than the policy behind section 1563(a), the Tax Court would not allow the fourth doctor's 25 percent interest in the partnership to be aggregated with the other three doctors' 75 percent interest. The resulting failure to satisfy the controlling interest test would enable the professional corporation's pension or profit-sharing plan to remain beyond the reach of section 414(c).

The circuit courts of appeals, however, are lining up against the Tax Court's position.[29] The Fourth Circuit, for example, reversed the Tax Court's decision in *Fairfax Auto Parts, Inc.*, finding that the dissenting opinion therein provided a better interpretation of section 1563(a)(2) in light of its legislative history.[30] That dissent concluded that stock owned by any or all of the five or fewer persons may be considered for purposes of the 80 percent controlling interest test and that each person need not own an interest in each organization within the brother-sister group.[31]

The dissenting opinion in *Fairfax* disagreed with the majority's view of the thrust of the statutory language. The dissenters considered the two-pronged test for a brother-sister controlled group in their statutory order, addressing the ownership interests of five or fewer persons for the 80 percent controlling interest test before turning to the effective control test. The dissenters reasoned that the purpose of the effective control test was to assure common control of each member of the brother-sister group by some of the persons counted in the

27. *See, e.g.*, Fairfax Auto Parts, Inc., 65 T.C. at 804.

28. The United States Court of Claims recently agreed that the Tax Court's analysis in *Fairfax* is "the most careful and best analysis of the statute to date." Vogel Fertilizer Co., 46 A.F.T.R.2d 80-5564 (Ct. Cl. 1980).

29. *See* Allen Oil Co., 614 F.2d 336, 45 A.F.T.R.2d 80-560 (2d Cir. 1980), *rev'g* 38 T.C.M. 355 (1979); T.L. Hunt, Inc., 562 F.2d 532, 40 A.F.T.R.2d 77-5709 (8th Cir. 1977), *rev'g* 35 T.C.M. 906 (1976); Fairfax Auto Parts, Inc., 548 F.2d 501, 39 A.F.T.R.2d 77-670 (4th Cir. 1977), *rev'g* 65 T.C. 798 (1976).

30. Fairfax Auto Parts, Inc., 548 F.2d 501, 39 A.F.T.R.2d 77-670 (4th Cir. 1977), *rev'g* 65 T.C. 798, 808 (1976).

31. 65 T.C. at 808.

controlling interest test,[32] and that the "each such person" clause within the effective control test could not place a common ownership limitation upon the controlling interest test.

The dissenting opinion in *Fairfax* also examined the legislative history underlying the two-pronged test for a brother-sister controlled group.[33] The legislative history, however, does not specifically deal with the issue of which ownership interests to aggregate for the controlling interest test. Thus, neither opinion is very persuasive in its determination of congressional intent. As to construction, the dissenting opinion in *Fairfax* is preferable in that it approaches the two-pronged test in statutory order. If a common ownership requirement is imposed upon the first step, the controlling interest test would tend to overlap the effective control test's identical ownership requirement. The dissent's approach seems more reasonable in that its construction of the two-pronged test gives force and effect to each of the provisions and avoids the possibility that the effective control test could be rendered meaningless by the imposition of a common ownership requirement upon the controlling interest test.

Avoidance of the Control Tests

Regardless of the relative strengths and weaknesses of the opposing opinions in *Fairfax,* it is clear that the Tax Court is deciding the issue in one way and the Fourth Circuit, and more recently the Second and Eighth Circuits,[34] in another. While the Tax Court will not follow the position of the dissent in *Fairfax* in cases appealable to those three appellate courts under the so-called "Golsen Rule,"[35] the uncertainty as to what constitutes a brother-sister controlled group under section 414(c) remains with tax planners in the other circuits. The recent Tax Court case of *Lloyd M. Garland, M.D., P.A.,*[36] however, illustrates how easy it is to avoid section 414(c) in the context of a partnership of professional corporations without ever confronting the 80 percent controlling interest test.

The petitioner in *Garland* was a professional association organized pursuant to the laws of Texas and incorporated in 1973. Garland was the sole employee and shareholder of that corporation. Prior to 1973, Garland had practiced medicine in partnership with another doctor, but the partnership was dissolved. After the dissolution Garland's corporation and his former partner entered into a new partnership in which each partner owned a 50 percent interest in the profits. Garland's professional corporation adopted a pension plan that qualified under section 401, and the corporation made contributions to the plan on behalf of Garland and the employees of the partnership. After the enactment of ERISA, however, the corporation amended its

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32. *Id.* at 809.
33. *Id.* at 811.
34. *See* Allen Oil Co., 614 F.2d 336, 45 A.F.T.R.2d 80-560 (2d Cir. 1980); T.L. Hunt, Inc., 562 F.2d 532, 40 A.F.T.R.2d 77-5709 (8th Cir. 1977).
35. *See* Jack E. Golsen, 54 T.C. 742 (1970).
36. 73 T.C. 5 (1979).

plan to exclude the partnership employees from its coverage and sought a ruling as to the plan's qualified status. The National Office of the Technical Services Branch issued a ruling in July 1976 stating that the partnership and the professional corporation were not under common control as defined by section 414(c) and the temporary regulations thereunder. Consequently, the employees of the partnership were not considered employees of the professional corporation for purposes of the coverage and anti-discrimination provisions of sections 410(b)(1) and 401(a)(4).[37]

The parties to the *Garland* case both agreed that section 414(c) did not apply because the partnership and the professional corporation were not members of any of the three types of controlled groups enumerated in the temporary regulations.[38] The court explained that the corporation did not belong to a brother-sister controlled group as defined by section 11.414(c)-2(c) of the temporary regulations because

> [t]hat regulation requires five or fewer persons to be in effective control of both the Association and Partnership, taking into account the ownership of each person only to the extent that his ownership is identical with respect to each entity. Effective control with respect to partnerships is defined in section 11.414(c)-2(c)(2)(iii), Income Tax Regs., as the ownership of more than a fifty percent interest in profits or capital. Under the contructive ownership rules of section 11.414(c)-4(b)(4), Income Tax Regs., Dr. Garland is deemed to own the fifty percent profits interest which the association owns. However, since [the other doctor] does not own any stock in the Association, his interest in the Partnership cannot be considered in determining whether he and Dr. Garland have effective control of the Partnership. Thus, they do not have effective control because Dr. Garland's constructive interest does not exceed fifty percent.[39]

Dr. Garland's situation was undisputedly outside the reach of section 414(c) based upon the failure of the more than 50 percent effective control test for a brother-sister controlled group. The case illustrates the ease with which section 414(c) can be avoided without confronting the problem presented in the *Fairfax* case where ownership interests were aggregated in satisfaction of the 80 percent controlling interest test.

Returning to the factual situation where three doctors form a professional corporation as a 75 percent general partner to a group medical practice, the issue of whether the fourth doctor's 25 percent interest in the partnership is counted towards the 80 percent controlling interest test can be avoided by simple planning. Each of the three doctors could incorporate separately, and

37. *Id.* at 7.

38. *Id.* at 9-11.

39. *Id.* at 11 n.8. In that same note, the court also stated that the partnership and Dr. Garland's corporation did not constitute a parent-subsidiary controlled group because §11.414 (c)-2(b) of the temporary regulations would require the corporation to have been a common parent organization which directly owned 80% of the partnership. Furthermore, the court noted that the partnership and the professional corporation did not constitute a combined group pursuant to §11.414(c)-2(d) of the regulations, for that regulation requires a combined group to include three or more organizations at least one of which is a common parent organization.

none of the resulting professional corporations would be deemed to belong to a brother-sister group of trades or businesses under common control. The more than 50 percent effective control test, the second prong of the two-step test for a brother-sister group, would not be satisfied because the identical ownership would be only 25 percent for all of the corporations. Therefore, section 414(c) would not apply to treat the partnership's employees and the sole employee of each professional corporation as employed by a single employer. Each professional corporation could then adopt a qualified pension plan covering only its sole employee-doctor, unless it could be successfully argued that the employees of the partnership were attributed to the corporate parnters notwithstanding the inapplicability of section 414(c).

ATTRIBUTION OF EMPLOYEE TO CORPORATE PARTNERS

In Revenue Ruling 68-370[40] the Service officially established its position with respect to the qualification of corporate general partners' retirement plans that exclude the employees of the partnership from their coverage. The relevant facts of the ruling are that *M* corporation and unrelated *X* corporation were general contractors engaged in the construction business. The two unrelated corporations entered into a joint venture for the performance of construction contracts awarded to them. The joint venture had its own employees, and none of those employees had ever performed services directly for *M* or *X* corporations. *M* corporation established a profit-sharing plan for its employees which did not cover the employees of the joint venture. *M* corporation then sought the advice of the Service as to whether its profit-sharing plan was required to take the employees of the joint venture into account in determining whether the plan met the listed requirements for qualification under section 401(a) of the Code.

After concluding the joint venture of the two corporations was a partnership for federal income tax purposes within the meaning of sections 761(a) and 7701(2) of the Code, the Service stated:

> [O]nce the requisite employment relationship is established between the partnership and the individuals who are rendering services to the partnership, such relationship is also established between each corporate partner and the employees for purposes of sections 401 through 404 of the Code . . . . The sole effect of such conclusion is to attribute to each partner the employment relationship that exists between the partnership and the individuals.[41]

The Service concluded:

> [S]ince the employees of the joint venture in this case are considered employees of *M*, it is held that such employees, and *M*'s distributive share of the compensation paid to them, must be taken into account in determining whether *M*'s profit-sharing plan meets the coverage and nondiscrimination requirements set forth in section 401(a) of the Code.[42]

40. Rev. Rul. 68-370, 1968-2 C.B. 174.
41. *Id.*
42. *Id.*

The Service's stance under Revenue Ruling 68-370 is that if pension or profit-sharing plans of the corporate general partners do not cover the employees of the partnership in a nondiscriminatory manner those plans are not qualified. Because the Service cited no statutes or case law as authority for its conclusion in the ruling, it is perhaps surprising that several years elapsed before the Service was challenged in court. In 1978, however, the Service's position was litigated in *Thomas Kiddie, M.D., Inc.*[43]

In *Kiddie*, separate professional corporations were established by two medical doctors. Each doctor was the sole shareholder and sole employee of his own corporation, and the two corporations formed a partnership to provide medical services. The partnership employed the staff, and each corporation shared equally in the partnership profits. On December 1 of the same year, one of the professional corporations adopted a pension plan for its sole employee and attempted to claim deductions for 1972 and 1973 contributions to the plan even though there was no comparable plan for the employees of the partnership.

The Internal Revenue Service, relying on its position under Revenue Ruling 68-370, disallowed these deductions.[44] The Service contended that the employees of the partnership were considered employees of the professional corporation for purposes of plan qualification and, accordingly, asserted that the plan failed to satisfy the discrimination test of section 401(a)(3).[45] The Tax Court did not agree. The court stated that generally "attribution of partnership characteristics to a partner does not occur unless that partner controls the partnership."[46] After focusing on control,[47] the court attempted to define con-

43. 69 T.C. 1055 (1978).

44. Generally, I.R.C. §404(a)(5) provides that if a plan is not qualified, the employer cannot claim a deduction for a contribution to that plan until the taxable year in which an amount attributable to that contribution is includible in the gross income of employees participating in the plan.

45. I.R.C. §401(a)(3) requires the plan to satisfy the requirements of §410. Section 410 in turn deals with minimum coverage and participation standards. Since the Service contends that the employees of the partnership are attributed to the corporate general partners, obviously its position is that the professional corporation's pension plan could not be qualified unless it covered the partnership's employees nondiscriminatorily.

46. 69 T.C. at 1060.

47. Despite the Tax Court's focus on control, the Service's position in Revenue Ruling 68-370 did not involve a control concept at all. There, the Service attributed the employees of a joint venture to its two corporate members but did not require either member to be in control prior to this attribution. Since the Service concluded in the ruling that the corporate members' profit-sharing plans would have to take into account the joint venture's employees to the extent of each member's distributive share of the employees' compensation, the Service is apparently attempting to analogize the attribution of employees to the conduit features of a partnership as illustrated by §702. Section 702 requires each partner to take into account his distributive share of certain income and deduction items of the partnership, and the Service was apparently relying on such a principle in the ruling. Letter Ruling 78-52096 emphasizes the fact that the Service's position relies on a conduit principle and not a control concept. Despite the fact that there were 22 equal general partners, none of whom controlled the partnership in any sense, the Service nevertheless maintained that the partnership employees were attributed to the general partners and required to be taken into account in the plans of the corporate partners to the extent of each partner's distributive share of the employees' compensation. Also, note that despite *Kiddie's* tacit rejection of the 1968 ruling, the 1978 letter ruling indicates the Service has continued to assert its stance under that ruling.

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trol in the context of attributing the partnership employees to the partners for purposes of qualification of the pension or profit-sharing plans of a corporate general partner. While admitting lack of a universal definition of control, the court examined section 707(b) of the Code, which defines a partner's control of a partnership for two purposes.[48] Under section 707(b) a partner owning more than a 50 percent capital or profits interest cannot deduct losses arising from a sale or exchange of property between that partner and the partnership. Furthermore, that section provides that gains recognized from a sale or exchange of property between a partner and a partnership shall be considered ordinary income if that partner owns more than 80 percent of the capital or profits interest in the partnership.[49]

The Tax Court noted that the same percentage of ownership criteria was incorporated into the definition of control when dealing wth section 179 additional depreciation allowances and section 38 investment credits and concluded that the greater than 50 percent interest test is equally applicable in defining control of a partnership for purposes of section 401(a)(3).[50] Accordingly, the court held that because the corporate general partners each owned only a 50 percent interest in the partnership, neither partner controlled the partnership, and therefore the employees of the partnership were not attributed to the corporate partner that had adopted the pension plan.[51] Hence, the plan satisfied eligibility requirements of section 401(a)(3) and remained qualified.[52]

The premise of the Tax Court's decision in *Kiddie* is that partnership characteristics, such as the employment relationship between the partnership and its employees, are only attributed to controlling partners. The court relied upon the greater than 50 percent ownership definition of control contained in section 707(b). The court did not, however, support the application of its premise in the context of section 401(a)(3); it merely asserted that the partnership's employees are only attributed to controlling partners. There are basic policy differences between section 707(b) and section 401(a)(3). Section 707(b), as well as section 179 and section 38, deals with the tax treatment of transactions in property and the denial of certain tax benefits to transactions between a partnership and a controlling partner. The policy behind denying a loss deduction under section 707(b), for example, is that the relationship involved would enable a controlling partner to manipulate the partnership and generate fictitious losses or increase the basis of property for the purpose of depreciation.[53] Section 401(a)(3), conversely, does not involve property transactions. Rather, it merely seeks to insure that qualified plans do not discriminate against rank-and-file employees in their coverage. Therefore, if section

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48. 69 T.C. at 1060.

49. *See* I.R.C. §707(b)(3). The percentage of ownership interest of a partner is determined in accordance with the rules for constructive ownership of stock provided in §267.

50. 69 T.C. at 1060.

51. *Id.* at 1061.

52. The government did file a Notice of Appeal with the Ninth Circuit, but the appeal was ultimately dismissed.

53. H.R. REP. No. 1337, 83rd Cong., 2d Sess. 226 (1974), *reprinted in* 7 TAX MNGM'T (BNA) §704.

401(a)(3) is liberally construed within the bounds of its policy, perhaps the Service's position of attributing the employees to the general partners, notwithstanding the lack of control, is more consistent with the policy of section 401(a)(3). On the other hand, if the court's requirement of control is accepted as being the correct premise, the court's application of the greater than 50 percent test of section 707(b) should at least be appreciated for its objectivity.[54]

In *Lloyd M. Garland, M.D., P.A.*, as in *Kiddie*, the Service asserted its position under Revenue Ruling 68-370. The fact that both the Service and the petitioner, Dr. Garland's professional corporation, agreed that section 414(c) was inapplicable was only the starting point of the controversy. Several months after its initial ruling, the National Office issued a letter limiting the scope of its ruling to the inapplicability of section 414(c) and cautioned that it had not taken Revenue Ruling 68-370 into account. The professional corporation then submitted an application for determination of the plan's qualified status under section 401, whereupon the District Director issued an adverse determination because the plan did not cover the partnership's employees. Thus, the ultimate issue confronting the Tax Court was whether the partnership employees were considered employees of the professional corporation for the purposes of the anti-discrimination and coverage provisions of sections 401(a)(4) and 410(b)(1) even though the plan was beyond the reach of section 414(c).[55]

The Commissioner contended that section 414 was not intended to be the exclusive test for determining whether employees of affiliated entities should be aggregated for purposes of section 401.[56] It was also necessary for the Commissioner to ask the Tax Court to overrule its opinion in *Kiddie* because if the court in *Garland* had agreed that 414(c) was not an exclusive test, the employees of the partnership still would not have been attributed to Dr. Garland's professional corporation. The *Kiddie* case had held that the employment relationship between a partnership and its employees is not attributable to a partner unless the particular partner owns more than a 50 percent interest in the partnership.[57] Dr. Garland's corporation was only a 50 percent general partner.

The Tax Court held that section 414(c) is the exclusive means for determing whether employees of related trades or businesses should be aggregated for purposes of applying the anti-discrimination provisions of sections 401(a)(4) and 401(b).[58] It relied on a House Committee report explaining the need for

54. Although the *Kiddie* case was a pre-ERISA case, perhaps the Tax Court, in its tacit rejection of the Service's position and its focus on control, was persuaded by this legislation that deals with controlled groups.

55. I.R.C. §401(a)(3) requires a qualified plan to satisfy the minimum participation standard of §410. Section 410(b) sets forth objective standards as to the percentage of employees that must be covered by a plan's benefit in order for it to qualify. If it fails these objective requirements, the plan will not be qualified unless the Secretary finds the coverage not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated. If the employees of the partnership were attributed to Dr. Garland's professional corporation, the pension plan's coverage provision would not subjectively be found nondiscriminatory since it only covered Dr. Garland, a shareholder.

56. Lloyd M. Garland, M.D., P.A., 73 T.C. at 11.

57. *Id.* The *Kiddie* case arose prior to ERISA and therefore had not confronted the issue as to the exclusivity of §414(c).

58. *Id.* at 13.

sections 414(b) and 414(c) which clearly indicated that Congress was aware of the ability to circumvent the anti-discrimination provisions through the use of related business entities.[59] In the report it was stated that sections 414(b) and 414(c) were intended to "clarify this matter for the future."[60] The court reasoned:

> In light of this direct Congressional response to the employee attribution problem and the express statement of intent to clarify this matter for the future, we see no reason to fortify the provisions of section 414(c) with other, more stringent tests.[61]

The Tax Court also pointedly mentioned that the Commissioner was "unable to advance a single cogent argument" in support of the claim that section 414(c) was not intended to be an exclusive test in this area and stated that the "mere fact that the statute does not explicitly state that it is the exclusive test does not necessarily imply that the reverse is true."[62] Apparently, the Commissioner had merely repeated his stance under Revenue Ruling 68-370.[63]

The Tax Court's decision that section 414(c) is the exclusive test despite the absence of specific statutory language to that effect is not without precedent. For example, section 334(b)(2) provides that in the case of certain liquidation distributions from a subsidiary to its parent, the parent's basis in the assets received is essentially the cost basis of the parent's stock. This provision is a statutory codification of the principle underlying the judicially created *Kimbell-Diamond* doctrine.[64] Unlike the judicially created doctrine that focuses on the subjective intent for the purchase of stock, section 334(b)(2) contains precise

59. H.R. REP. No. 93-807, 93rd Cong., 2d Sess. 49 (1974), 1974-3 C.B. 285 (Supp.). See note 6 *supra*.

60. *Id.*

61. 73 T.C. at 13.

62. *Id.* at 12. The Tax Court alternately held that even if §414(c) were not the exclusive test for aggregating employees of affiliated organizations, the *Kiddie* case would still allow the petitioner to prevail. One could contend that the principles of *Kiddie* could still come into play and cause such aggregation in instances where a more than 50% partner failed the 80% controlling interest test of Temp. Reg. §11.414(c)-2(1). This contention might be bolstered by a sentence in the committee report which the Tax Court in *Garland* neglected to mention. After stating that §414(c) was intended to clarify this matter for the future, the committee stated that it "intend[ed] that prior law on this point be determined as if this provision had not been enacted." H.R. REP. No. 93-807, *supra* note 59. The more reasonable view, however, would seem to be that *Kiddie* could not come into play in the future. The Tax Court was exceedingly clear that its holding was that §414(c) is the exclusive test and that it would not fortify §414(c) with other tests. The alternate holding in *Garland* may have been set forth merely to avoid reversal on appeal (though *Garland* was not appealed), and the language in the committee report may have meant only that §414(c) was not intended to apply retroactively.

63. *See* 73 T.C. at 14 n.10. The Tax Court stated that it saw "no rational connection between the conduit principle of sec. 702 and the employee attribution issue." *Id.*

64. Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 847 (1951). Simply stated, the *Kimbell-Diamond* doctrine prescribes that if the intent and the effect of a purchase of stock and a liquidation of an acquired corporation is to purchase the assets of that corporation, then the series of transactions should be viewed as a simple purchase of those assets.

objective standards for determining whether a parent corporation can take a section 334(b)(2) basis as opposed to the section 334(b)(1) carryover basis. Thus, it is not surprising that courts have confronted the issue of whether section 334(b)(2) is the exclusive test in the area. Although the Court of Claims holds otherwise,[65] the Tax Court and three courts of appeals have held that the *Kimbell-Diamond* doctrine was replaced by section 334(b)(2) despite the lack of both express statutory language to that effect and clear legislative history.[66] The Fifth Circuit, for example, reasoned that Congress was aware of the *Kimbell-Diamond* doctrine, yet provided for only the objective exception to the carryover basis rule of section 334(b)(1). That court refused to act as a "paternal rectifier of legislation which is not constitutionally deficient."[67]

If the Tax Court and the Courts of Appeals can hold that section 334(b)(2) is the exclusive test in a situation where a strong, judicially created doctrine is supplanted by so holding, the Tax Court in *Garland* certainly is not taking an unprecedented position by holding section 414(c) to be an exclusive test. In *Garland* the Tax Court's holding does not affect any established common law doctrine. It merely prevents the Service from fortifying section 414(c) with the unsubstantiated stance it took in Revenue Ruling 68-370.

THE PROPOSED LEGISLATION

The *Garland* case's repudiation of the Service's approach to the aggregation of employees of affiliated entities allows professionals engaged in group practices to circumvent easily the coverage and anti-discrimination provisions in the employee benefit area of the Code. Section 414(c) is of little significance due to its limited scope. It can be avoided by merely incorporating each professional partner separately, thereby causing the failure of the control tests thereunder. As a result, legislation aimed directly at professional organizations has been proposed. Identical bills were introduced in both the House of Representatives and the Senate[68] expressing concern that

> if the *Kiddie* and *Garland* cases became an accepted part of the pension law, the intent of the Congress in providing tax incentives for qualified plans that benefit rank-and-file workers will be frustrated. The bill . . . is designed to prevent this abuse before it becomes widespread.[69]

These bills would add a new subsection 414(m) to the Code and require that

> for purposes of sections 401, 408(k), 410, 411, and 415, all employees of an adjunct professional organization, and all employees of the profes-

65. *See* American Potash & Chem. Corp. v. United States, 399 F.2d 194, 22 A.F.T.R.2d 68-5161 (Ct. Cl. 1968).

66. *See In re* Chrome Plate, Inc. v. United States, 614 F.2d 990, 45 A.F.T.R.2d 80-1241 (5th Cir. 1980); Broadview Lumber Co. v. United States, 561 F.2d 698, 40 A.F.T.R.2d 77-5650 (7th Cir. 1977); Pacific Transp. Co. v. Commissioner, 483 F.2d 209, 32 A.F.T.R.2d 73-5663 (9th Cir. 1973); International State Bank, 70 T.C. 173 (1978).

67. *In re* Chrome Plate, Inc. v. United States, 614 F.2d 990, 1000, 45 A.F.T.R.2d 80-1241, 80-1248 (5th Cir. 1980).

68. S. 2128, 96th Cong., 1st Sess. (1979); H.R. 6140, 96th Cong., 1st Sess. (1979).

69. 125 CONG. REC. H12,006 (daily ed. Dec. 13, 1979) (remarks of Rep. Ullman).

> sional organizations which are related to such adjunct professional organization, shall be treated as employed by a single employer.[70]

The term adjunct professional organization is statutorily defined as an organization whose employees perform services for persons who perform professional services.[71] Professional services include, but are not limited to, services performed by physicians, dentists, attorneys and public accountants.[72] Because the term organization encompasses partnership,[73] a partnership of professional corporations that avoids section 414(c) is subject to this provision. For example, if the rank-and-file employees of a group medical practice are placed under the employ of a partnership of incorporated doctors, the partnership would constitute an adjunct professional organization because it is an "organization whose employees perform services for persons who perform professional services." The term persons is not defined in the proposed legislation but would apparently include the individual professionals as well as the professional corporation.[74] Therefore, if the required relationship between the adjunct professional organization (the partnership) and the professional organization (the professional corporations) is established, the aggregation of all employees would occur for purposes of plan qualification.

The crucial part of the legislation is the definition of this required relationship. The bills state that a professional organization is related to an adjunct professional organization if

> (A) the professional organization regularly uses the services of the adjunct professional organization . . . in performing professional services for third persons,
> (B) 1 or more of the individuals performing services for the professional organization . . . owns an interest in the adjunct professional organization, and
> (C) 25 percent or more of the interests in the adjunct professional organization is owned by persons described in (B).[75]

The term regularly is not defined within the bills, and therefore any future regulation interpreting that term could be extremely important in limiting or expanding the applicability of the statute. For example, would a brief combination of a professional and adjunct organization in a joint venture qualify as regular use of the services of the adjunct organization? If so, this legislation could overreach the intent of Congress to prevent *Kiddie* and *Garland*-type abuses of the pension law.[76]

The broad scope of the relationship test can be illustrated by way of an example. Assume five unrelated doctors engaged in a group medical partnership each separately incorporate with each professional corporation owning a

70. S. 2128, §414(m)(1).
71. S. 2128, §414(m)(3).
72. S. 2128, §414(m)(6)(A).
73. S. 2128, §414(m)(6)(B).
74. I.R.C. §7701(a)(1).
75. S. 2128, §414(m)(5).
76. *See* 125 CONG. REC. H12,006 (daily ed. Dec. 13, 1979) (remarks of Rep. Ullman).

20 percent profits interest in the partnership. The rank-and-file employees remain employed by the partnership directly, and each professional corporation adopts a pension plan covering its sole professional employee. The professional corporations regularly use the services of the partnership employees and thus paragraph (A) is satisfied. In determining ownership for proposed section 414(m), the bills provide that the principles of section 267 shall apply.[77] Because section 267(b)(2) would attribute the partnership interest owned by each professional corporation to each corporation's sole shareholder-doctor, paragraph (B) is met.

The third part of the relationship test requires that 25 percent or more of the interests in the partnership must be owned by persons described in paragraph (B). Here, the proposed legislation appears to have left no question as to which ownership interests are aggregable for purposes of this 25 percent test. All five doctors are "persons described in (B)," as each is deemed to own an interest in the partnership. Therefore, paragraph (C) is satisfied because 100 percent of the partnership is owned by persons described in paragraph (B). Thus, it is apparent that Congress has been careful to see that no issues arise in section 414(m) concerning which ownership interests to aggregate. That is, by referring to "persons described in paragraph (B)" in the plural, Congress clearly intended that all five doctors' 20 percent ownership interests in the partnership were to be counted in meeting the 25 percent test of subparagraph (C). By satisfying the required relationship between the professional corporations and the partnership, the pension plans would not remain qualified without taking the partnership employees into account.[78]

Section 414(m), if enacted, would throw a broad net over partnerships of professional corporations that use such an organizational form to circumvent the coverage and anti-discrimination provisions of the Code. The statute has only one slight gap which is probably of little practical significance. If just one of the five doctors incorporated and the other four remained individual partners, the single professional corporation would not be related to the partnership and could adopt a plan covering only its sole employee. This results from the fact that only the ownership interests of "persons described in paragraph (B)" are aggregated for the 25 percent test. Because the fifth doctor would be the only individual performing professional services for the professional corporation, he alone would be encompassed by paragraph (B). Therefore, only the 20 percent interest in the partnership attributed to him under section 267 would be counted under the 25 percent test of paragraph (C).[79]

THE HIRING OF INDEPENDENT CONTRACTORS RATHER THAN EMPLOYEES AND ITS EFFECT ON QUALIFICATION

At least two commentators have discussed the fact that the Service has re-

77. S. 2128, §414(m)(6)(C).

78. Tax planners who are considering using *Garland*-type pension or profit-sharing plans prior to the enactment of this legislation should note that the statute will be retroactively applied to plan years ending after December 13, 1979, the date on which the bills were introduced in Congress.

79. S. 2128, §§2(a), 414(m).

lied on Revenue Ruling 68-370 without arguing that the partnership should be disregarded as a sham and its employees attributed to the corporate partners for whom they perform services.[80] A related argument is that the partnership's employees were in fact directly employed by the professional corporations, not the partnership.[81] The case of *Edward L. Burnetta, O.D., P.A.*[82] involved the latter approach.

In *Burnetta,* the only individual receiving paychecks from the professional corporation was Dr. Burnetta. The staff workers for the medical practice were provided by an arguably unrelated company whose slogan was "regular employees of *your* work on *our* payroll."[83] During the years at issue, Dr. Burnetta was the only individual to be credited with pension and profit-sharing contributions by the professional corporation. The corporation maintained that its plans were qualified because Dr. Burnetta was its only employee. The corporation did not pay its "leased" office workers directly. Rather it paid the company with which it had contracted for their services.

The obvious contention by the Service was that an employer-employee relationship in fact existed between the professional corporation and its leased workers, thereby disqualifying the professional corporation's plans for failure to comply with the coverage requirements of section 410(b). In reaching its conclusion, the Tax Court looked to common law concepts to define employee for purposes of section 401 and concluded that one of the workers was in fact the common law employee of the professional corporation.[84] Although many factors were considered in linking the employee to the corporation, the Tax Court relied most heavily on the right of the corporation to control and direct the individual in performance of his duties.[85]

The purpose of this cursory examination of the *Burnetta* case is not to analyze fully the factors involved in determining whether an individual is in

80. Grant & Ward, *Will Garland Case Now Permit Partnerships of P.C.s to Avoid Qualified Plan Rules?*, 52 J. TAX. 3 (1980). One way to attack the existence of the partnership is to argue that it is merely an expense sharing arrangement and therefore it is not deemed to be a partnership for federal tax purposes pursuant to §1.761-1(a) of the income tax regulations. Such an argument would seem ineffective in the area of a partnership of professional corporations engaged in a group practice because the partnership probably has more substance and function than an arrangement merely to share expenses.

If §482 is used to attack the partnership as a sham, as opposed to a complete nonrecognition of its existence for federal tax purposes, perhaps the Service could allocate the partnership's deductions for the rank-and-file workers' salary expense to the professional corporations. If successful, the employment relationship should flow to the professional corporations also, thereby forcing the plans of the corporations to cover "their employees."

81. *Id.*

82. 68 T.C. 387 (1977).

83. *Id.* at 391.

84. *Id.* at 398.

85. Currently, there is a bill pending in Congress which would provide a statutory safe harbor for determining when an individual would not be classified as an employee. *See* H.R. 5460, 96th Cong., 1st Sess. (1979). Although originally restricted to the employment tax area, technical amendments to H.R. 5460 were approved by a sub-committee of the Ways and Means Committee on November 27, 1979, which provide that an individual treated as an independent contractor under the bill shall not be treated as an employee for employer-provided fringe benefits. Such benefits would encompass plans of deferred compensation.

an employee or independent contractor relationship with an allegedly qualified plan sponsor. It is merely intended to raise the possibility of the Service utilizing that approach to attribute the workers paid by the partnership to the professional corporations that are general partners. Ultimately, however, such an effort by the Service would probably not prevail where the entire organization is engaged in a single group professional practice. The principles of *Burnetta* would seem more applicable to a situation where the professional corporations were engaged in distinct, segregated businesses and the rank-and-file workers of all the unrelated businesses were placed on the payroll of the partnership under the guise of being independent contractors.[86]

Perhaps the Service could mount a more sophisticated and effective attack by completely disregarding the existence of the professional corporations for federal tax purposes.[87] With such an approach the professional corporations obviously could not sponsor qualified plans under section 401. In *Moline Properties, Inc.*,[88] the leading case in the area of corporate non-recognition, the general rule was established that a corporation will be recognized regardless of the purpose for incorporating "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation."[89]

In the context of a professional group practice, the most logical manner of obtaining the advantages of corporate status is to incorporate the entire practice so that both the professionals and the rank-and-file workers are employees of the single professional corporation. A persuasive argument could be made

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86. Grant & Ward, *supra* note 80, at 3. If a *Burnetta*-type attack is used successfully by the Service to attribute the partnership employees to the professional corporations in a particular case, a recent letter ruling illustrates that the Service will be forced to use *Burnetta* on a case by case basis. In Letter Ruling 7947002, corporation *M* provided clerical, clinical, and laboratory workers for independent professional corporations. The Service heard that the workers were the employees of corporation *M* for purposes of the coverage requirements of the Code. The Service distinguished the facts from *Burnetta* because there was an employment contract between corporation *M* and the workers, and corporation *M* had also trained the workers. The most important factual distinction from *Burnetta* as a practical matter, however, is that corporation *M* had applied for and received a ruling from the service that the workers were the employees of corporation *M* for purposes of employment taxes. Therefore, the employment tax ruling forced the decision in Letter Ruling 7947002. Otherwise, the Service would have had to take an inconsistent position as to which entity employed the workers. This ruling could open up planning possibilities for professional corporations in the deferred compensation area.

87. A related argument could be made under §482 in particular fact situations. For example, if doctors in a group medical practice, organized as a partnership of professional corporations, are functioning as partners individually and the partnership agreement does not recognize the corporations' existence, the Service could possibly allocate the income to the individuals instead of to the corporations. It would then seem likely that the professional corporations could not sponsor qualified plans for the doctors because the doctors, after the allocation, would be deemed to earn their salaries directly from the partnership. *Cf.* Borge v. Commissioner, 405 F.2d 673, 23 A.F.T.R.2d 69-320 (2d Cir. 1968) (income allocated from corporation to sole stockholder who had earned it).

88. 319 U.S. 436 (1943).

89. *Id.* at 437.

that the sole purpose of establishing separate professional corporations as general partners is to evade the coverage and antidiscrimination provisions of the employee-benefit area of the Code and hence the professional corporations should be disregarded as shams. In a situation where the existence of a single corporation is involved, the Supreme Court in *Moline* stated that the purpose for incorporating is usually irrelevant when the corporation is in fact carrying on business.[90] Business activity carried on by the several professional corporations, however, should not be considered in establishing their existence as taxable entities where the purpose of their formation was solely to avoid taxes. Thus, an argument can be made that the business activity rule of *Moline* should not apply and that the professional corporations should be ignored as shams.

To bolster this argument, it is important to emphasize the fact that *Moline* involved a situation where the taxpayer himself sought to ignore his own corporation's existence for federal tax purposes. The Tax Court has recognized that it is more difficult for a taxpayer to win such a case than it is for the government to successfully label a corporation a sham.[91] In stating the general rule that a corporation's existence will be respected unless the corporation is a purely passive dummy or is used for tax avoidance purposes, the Tax Court noted, "[T]his is particularly true where the demand that the corporate entity be ignored emanates from the shareholders."[92] Thus, it is likely that the Commissioner can successfully label such professional corporations as shams due to the motive behind the formation of several separate corporations as general partners, notwithstanding the arguments of the professionals that these corporations carry on business activities. If successful, the professional would be forced either to incorporate the entire group practice and cover the rank-and-file employees or remain a partnership with its comparatively low Keogh plan limits.[93]

The arguments set forth above raise an important issue. The Tax Court in *Garland* held section 414(c) to be the exclusive means for determining whether employees of related trades or businesses should be aggregated for purposes of applying the antidiscrimination provisions of sections 401(a)(4) and 401(b).[94] That decision serves to prevent the Service's attribution of the partnership employees to the professional corporations merely upon the basis of the conduit nature of partnerships where the Service cannot apply the objective standards of section 414(c) successfully. It would certainly seem reasonable, however, to allow the Service the continued use of the common law doctrines of sham and employee versus independent contractor, as well as statutory income and deduction reallocation weapons such as sections 482 and 269, in attacking the form of a related group of individuals and entities on a case by case basis. The existence of section 414(c) and the holding of *Garland* would not appear to be inconsistent with that approach.

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90. *Id.*
91. *See* William B. Strong, 66 T.C. 12 (1976).
92. *Id.* at 22.
93. See note 1 *supra.*
94. Lloyd M. Garland, M.D., P.A., 73 T.C. at 13.

IS REVENUE RULING 68-370 COMPATIBLE WITH SECTION 414(c)?

Revenue Ruling 68-370 provides that a corporation which participates in a joint venture equally with another corporation must take the employees of the joint venture into account in determining whether that corporation's profit-sharing plan is qualified under section 401(a) of the Code.[95] The Service, however, has held that the corporation need only take those employees into account to the extent of that corporation's distributive share of the compensation paid to them.[96] Thus, if the corporation's profit-sharing plan provided an annual contribution of 10 percent of each participant's total compensation, apparently the ruling's position is that the corporation would only be required to contribute 10 percent of one-half of the total compensation of the joint venture's employees in order to remain qualified.

Although Revenue Ruling 68-370 was issued prior to ERISA and the enactment of section 414(c), the Service has continued to apply it in instances where section 414(c) does not apply. For example, in Letter Ruling 7834054 the Service conceded the inapplicability of section 414(c) to a partnership of three equal professional corporations, yet insisted that the partnership's employees were still attributed to the professional corporation and that the retirement plans of those corporations must take the employees of the partnership into account in order to remain qualified. The *Garland* case clearly held that the Service could not apply Revenue Ruling 68-370 to situations where section 414(c) does not apply. The interesting question, however, is whether the distributive share language of Revenue Ruling 68-370 could be used in situations where section 414(c) does apply. If so, the results obtained would become extremely advantageous to plans of professional corporations that fall into the clutches of the recent proposed legislation. Thus, the issue is whether Revenue Ruling 68-370 is compatible with section 414(c).[97] Section 414(c) is not explicit as to how employees of a partnership must be taken into account by the deferred compensation plans of a professional corporation when that corporation and partnership are under common control. It only states that all employees of such an organization must be treated as employed by a single employer.

For illustrative purposes, assume that Revenue Ruling 68-370 is indeed compatible with section 414(c). A professional corporation that owns an 80 percent interest in a partnership is required to take the partnership employees into account for purposes of sections 401, 408(k), 410, 411, and 415.[98] If that corporation contributed to a profit-sharing plan based on its employees' total compensation, apparently the contributions on behalf of the partnership employees could be based on 80 percent of their total compensation.[99] This result

95. Rev. Rul. 68-370, 1968-2 C.B. 174.

96. *Id.*

97. A recent telephone call to the Tax Legislative Council of the Treasury Department confirms that several other practitioners have informally inquired as to the possibility of using the distributive share holding of Revenue Ruling 68-370 in the context of §414(c).

98. *See* Temp. Reg. §11.414(c)-2(b), -2(c), 44 Fed. Reg. 19,285, 56,504 (1979).

99. If the corporation established a separate plan for the partnership employees that is not identical to the plan that covers the professional employees, then the question of com-

would become extremely beneficial to a professional corporation snared by proposed section 414(m).[100] As previously discussed, under that legislation, if a professional corporation is a 25 percent general partner of a partnership, all employees of the partnership and the professional corporation are treated as employed by a single employer. That is the same as the mandate of section 414(c) when it applies. Accordingly, if the principles of Revenue Ruling 68-370 are compatible, the professional corporation could adopt a qualified plan that benefits the corporation's sole professional employee to the full extent of his compensation and the other employees only to the extent of 25 percent of their compensation. Such a result would be desirable to professionals who organized their group practice with the purpose of avoiding section 414(c).

The successful use of the Service's distributive share position is viable because both the temporary regulations and Congressional intent are unclear as to what is required to satisfy section 414(c) when it applies. The statutory language itself only requires that "all employees of trades or businesses . . . which are under common control shall be treated as employed by a single employer" for purposes of sections 401, 408(k), 410, 411, and 415.[101] It does not specifically preclude the possibility that professional corporations could comply with section 414(c) by covering the partnership employees to the extent of that corporation's distributive share of their compensation.

The temporary regulations are of no help in resolving this matter. Section 11.414(c)-1 of the regulations merely states: "[S]ee sections 401, 410, 411, and 415 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control." Those statutory provisions and regulations, however, do not even mention section 414(c). Therefore, an argument for the compatibility of Revenue Ruling 68-370 with section 414(c) is not expressly precluded. On the other hand, the Service would probably contend that if a professional corporation's retirement plan covered its professional employees to the full extent of their compensation, the partnership employees must similarly be covered when section 414(c) applies.[102] The Service might interpret the statute's simple reference to sections 401, 410, 411, and 415 as indicating Congressional intent that the professional corporation's retirement plan must take the partnership employees into account as if they were the em-

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parability of benefits would arise. However, if Revenue Ruling 68-370 applies, the plans would not need to achieve 100% comparability of benefits in order for the two plans to meet the nondiscrimination requirements of §401(a)(4). *See* Sacher, *Using Qualified "Multi-Employers Plans" for Partnerships of P.C.s: A Current Appraisal,* 53 J. OF TAX. 211, 212 (1980).

100. S. 2128, 96th Cong., 1st Sess. (1979).

101. §414(c).

102. It is also possible that §414(c) might envision the partnership itself having a plan covering its rank-and-file employees. In order to satisfy §414(c), the partnership plan must compare favorably with provisions of the plan of the professional corporation in order for the corporation's plan to remain qualified. The partnership's plan would not be subject to the $7,500 deduction limitation of a Keogh plan (§404(e)) because §401(c) owner-employees would not be participating. Hence, the partnership would have a plan similar to the corporation's. The basis for this approach to §414(c) is that §401(a) states that a qualified plan is a plan of an employer for the benefit of his employees. The partnership remains the employer of the rank-and-file employees notwithstanding the applicability of §414(c).

ployees of that corporation, despite the fact that the corporation might not own 100 percent of the partnership.

The legislative history relating to section 414(c) is equally inconclusive as to whether or not a professional corporation could satisfy the statute by merely covering the partnership employees to the extent of its distributive share of their compensation. The applicable committee report stated that all the employees of organizations within section 414(c) must be taken into account in applying the coverage test, antidiscrimination rules, and the limits on contributions and benefits. But it did not explain to what extent they must be taken into account.[103] Furthermore, a professional corporation encompassed by section 414(c) (or proposed section 414(m)) can even make an equitable argument for the compatibility of Revenue Ruling 68-370.

Assume a group professional practice consisted of five professionals and five rank-and-file employees. If the entire business were incorporated as a single professional corporation, the corporation could adopt a qualified retirement plan that covers only four of the rank-and-file employees so long as the contributions or benefits do not discriminate in favor of the professionals. Next, assume further that instead of a single corporation, four of the five professionals in a group practice form a professional corporation that becomes an 80 percent general partner, with the rank-and-file employees remaining employees of the partnership. The professional corporation could make an equitable argument under section 414(c) that its retirement plan would not be discriminatory if it covered all five rank-and-file partnership employees to the extent of 80 percent of their total compensation even though the four professionals are covered to the full extent of their compensation.

If Revenue Ruling 68-370 is held to be compatible wth the recently proposed legislation, and the Service does not revoke or modify it, partnerships of professional corporations could continue to be an advantageous planning device in that a partner in a group practice could separately incorporate and adopt a retirement plan without having to cover all rank-and-file partnership employees to the full extent of their compensation. On the other hand, if section 414(c) and the proposed statute are interpreted to require a professional corporation's pension or profit-sharing plan to cover all the partnership's rank-and-file employees to the full extent of their total compensation, as opposed to its distributive share, professionals in a group practice would probably not opt to organize themselves into a partnership of professional corporations.

There is an alternative available to partnerships of professional corporations that avoids the uncertain methods of applying section 414(c) and the proposed legislation. The professional corporations and the partnership could join in establishing a multiple-employer plan under section 413(c). In that event, there would be one plan covering all the professionals and the rank-and-file employees,[104] and the partnership would make the contributions applicable to the partnership employees. This would solve the problem of the extent to

103. H. R. REP. No. 93-807, 93rd Cong., 2d Sess. 49 (1974).

104. A corporation and partnership can jointly maintain a multiple employer plan so long as it excludes self-employed individuals. Self-employed individuals are limited to the Keogh limitations of §§401(c) and 404(e).

which a separate plan of a professional corporation must cover the partnership employees.[105] In essence, section 413(c) provides that the qualification of such a plan is determined as if all employees of the employers maintaining the plan were employed by a single employer.[106]

CONCLUSION

If the proposed legislation is indeed enacted, several of the issues contained in this paper become moot in the context of a partnership of professional corporations. The issue of which ownership interests to aggregate in meeting the 80 percent controlling interest test for brother-sister controlled groups under section 414(c) will not be addressed, and an attempt by the Service to disregard the partnership in order to attribute its rank-and-file employees to the professional corporations will not be necessary. Partnerships of professional corporations will clearly fall within the scope of section 414(m). The issue as to the compatibility of the Service's position in Revenue Ruling 68-370 with partnerships of professional corporations encompassed by sections 414(c) or 414(m) will remain relevant and require resolution in the future.

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105. One author recently suggested that the professional corporations could join together and establish a single plan for the benefit of only the rank-and-file employees of the partnership while retaining the various plans for the shareholder-professionals. In that event the flexibility of a partnership of professional corporations would be retained to a much greater extent. *See* Sacher, *supra* note 99 at 210.

106. This alternative would also be available to professional corporations in situations where the partnership is disregarded as a mere expense sharing arrangement or a sham. In that event, however, the corporations would make the contributions on behalf of the rank-and-file employees. The corporations would have to compute their respective shares of those contribuitons.