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Professional Incorporation

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that the proviso found in section 57n[17] which allows for a grace period of thirty days can be construed to be included within the amendment to the "executory contract" provision so that timely filing can be possible.

It is clear that the amendments will, in addition to their expressed intended purpose, to wit, the elimination of preferences to creditors not previously required to file, provide a cutoff date after which confirmation of the plan can be accomplished with a degree of certainty. While, as we have seen, there are certain incidental drawbacks, the overall picture would seem to represent a positive step.

STEPHEN M. RICHMOND

CORPORATIONS

PROFESSIONAL INCORPORATION

Massachusetts recently amended the corporation section of its general laws by the addition of chapter 156A, the professional corporation statute.[1] This brings to forty the number of states which have enacted similar legislation. The primary purpose of the statute is to allow self-employed professionals to incorporate so that they may be recognized as "employees" within the definition of Internal Revenue Rulings,[2] and thus qualify for profit sharing and pension plans and the tax benefits to be derived therefrom. The enactment embraces specifically enumerated professions, *i.e.*, registered physicians and surgeons, chiropodists, physical therapists, dentists, veterinarians, optometrists and attorneys admitted to practice in the courts of the Commonwealth under chapter 221 of the Massachusetts General Laws.

Professional corporation statutes represent an attempt to eliminate the traditional and statutory prohibitions which have prevented the so-called professionals from rendering professional services through the corporate form. In Massachusetts, there are express statutory provisions prohibiting ordinary business corporations from practicing law[3] or dentistry.[4] While there are no similar statutory interdictions applicable to the other groups

[17] While this may involve a rather tenuous construction of such terms as "avoidance of lien" or "recovery" of funds, this would nonetheless seem to be a reasonable way to solve an apparently unforseen problem.

[1] Mass. Acts, 1963, ch. 654, adopted August 19, 1963, effective November 15, 1963. This note will be concerned primarily with the Massachusetts professional corporation statute. It is similar in most particulars to professional corporation and association statutes enacted in other jurisdictions. The purposes for which it was enacted and the policies which dictated its form and provisions are sufficiently identifiable with those of other jurisdictions so that it may serve to illustrate these purposes and policies and the functional possibilities made available by such enactments.

[2] Professional partnerships, composed of attorneys, physicians, etc., are entitled to the same privileges as corporations in the establishment of pension trusts for the benefit of bona fide employees of such partnerships. However, a general partner, as such, is not an employee of the partnership and is precluded from participating in the benefits of a trust. I.T. 3350, 1940-41 Cum. Bull. 65.

[3] Mass. Gen. Laws Ann. ch. 221, § 46 (1958).

[4] Mass. Gen. Laws Ann. ch. 112, § 49 (1958).

specified in the statute, such restrictions may be implied. These statutes make it illegal to practice such professions without being duly registered.[5] A corporation cannot possess the personal qualities, such as good moral character, required to obtain a license, and thus, a corporation rendering professional services would be practicing illegally,[6] absent statutory authority. At first glance such reasoning may appear to be very superficial, but there are cogent reasons for the restrictions. There is an inherent risk in permitting the interposition of the corporate entity between the professional and his patient or client. The professional would be responsible to the corporate management, which might consist of non-professionals, not subject to licensing boards or the compulsion of professional ethics. The employer's directives could well result in the rendition of services for the main benefit of the employer, and not in accordance with the best interests of patient or client.[7]

The dangers inherent in allowing professionals to render services through the corporate entity are precluded by the provisions of chapter 156A. The statute allows the corporation to render only one specific type of professional service,[8] and all shareholders, officers and directors are required to be licensed to perform that one service.[9] Shares of the corporation's capital stock may only be transferred to persons registered to perform the same professional service.[10] The jurisdiction of licensing boards extends to all professionals, notwithstanding such person is an officer, director, shareholder or employee of a professional corporation.[11] Finally, the statute does not alter the liability of the professional, in the rendition of professional services, to the person receiving such services.[12] These provisions avoid divided allegiances and place the corporation as a whole, through its various parts, under the control of the appropriate licensing board. Attorneys will be allowed the use of the statute to the extent that the Supreme Judicial Court approves and makes such terms and conditions as it deems necessary and appropriate.[13] In view of the obvious effort to maintain professional relationships and responsibilities, it seems apparent that former

[5] Mass. Gen. Laws Ann. ch. 112 (1958): physicians and surgeons, § 6; chiropodists, § 14; optometrists, § 72A; veterinarians, § 59. Veterinary hospitals and companies are allowed to incorporate in Massachusetts provided that the veterinarian receives compensation for his services directly from his clients, and not through the corporation.

[6] McMurdo v. Getter, 298 Mass. 363, 10 N.E.2d 139 (1937); Kerner v. United Medical Serv., Inc., 362 Ill. 442, 200 N.E. 157 (1936).

[7] See In Re Co-op. Law Co., 198 N.Y. 479, 92 N.E. 15 (1910); McMurdo v. Getter, supra note 6; In Re Opinion of the Justices, 289 Mass. 607, 194 N.E. 313 (1935). Contra, State Electro-Medical Institute v. State, 74 Neb. 40, 103 N.W. 1078 (1905).

[8] Mass. Gen. Laws Ann. ch. 156A, § 4 (Supp. 1963).

[9] Mass. Gen. Laws Ann. ch. 156A, § 8 (Supp. 1963).

[10] Mass. Gen. Laws Ann. ch. 156A, § 7 (Supp. 1963).

[11] Mass. Gen. Laws Ann. ch. 156A, § 11 (Supp. 1963).

[12] Mass. Gen. Laws Ann. ch. 156A, § 10 (Supp. 1963).

[13] Mass. Gen. Laws Ann. ch. 156A, § 17 (Supp. 1963). This provision is inserted in recognition of the jurisdiction of the Supreme Judicial Court over the practice of law in the courts of the Commonwealth. "Permission to practice law is within the exclusive cognizance of the judicial department." In Re Opinion of the Justices, supra note 7, at 613, 194 N.E. at 316. Cf. State v. Brown, 173 Ohio St. 114, 180 N.E.2d 157 (1962).

restrictions on business corporations practicing law or the professions are in no way abrogated by this statute.[14]

The professional corporation can be organized by one or more persons,[15] as opposed to the three required for this purpose under the business corporation provisions of chapter 156.[16] Chapter 156 requires not less than three directors.[17] While chapter 156A is silent as to director requirements, it appears that a lesser number of directors is acceptable in order to effectuate the design of the Act.[18] There would appear to be a modified limited liability in the professional corporation. Although personal liability is not annulled by the corporate form when it arises out of the rendition of professional services, there is, apparently, limited liability on general corporate contract debts and on claims arising out of tort actions not associated with the rendition of services as, *e.g.*, injury to a business invitee caused by negligently maintained corporate premises.

Apart from possible tax benefits, there are no extraordinary reasons for professionals to incorporate. The modified limited liability may be attractive, depending on the fact situation. Also, the continuity of life possessed by a corporation may eliminate some inconvenience present in a partnership when death or other factors causes a dissolution.[19] One final incentive to incorporate under chapter 156A may be to avoid the joint and several liability of partners for the act of one of them.[20] In the corporate form, only the person personally responsible and the corporation itself would appear to be liable. However, the importance of this factor is diminished somewhat when it is recognized that professionals, by reason of the personal nature of the services they render, would likely be substantially insured against personal liability, whether they practice in a corporation or a partnership. Thus, even in a partnership, it is improbable that liability, arising out of the act of one partner, would result in execution of a judgment on the other partner's assets. Of course, these considerations must be viewed in terms of the particular situation and the advantages balanced against any disadvantages as, *e.g.*, in Massachusetts, the taxes and fees imposed on corporations.[21]

As previously indicated, the primary purpose of enacting professional corporation and association statutes is to permit professional people to qualify for tax treatment as employees with respect to qualified pension and

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[14] See State Bd. of Accountancy v. Eber, 149 So.2d 81 (Fla. Dist. Ct. App. 1963).

[15] Mass. Gen. Laws Ann. ch. 156A, § 2 (Supp. 1963).

[16] Mass. Gen. Laws Ann. ch. 156, § 6 (1958).

[17] Mass. Gen. Laws Ann. ch. 156, § 21 (1958).

[18] Accord, Christian v. Shideler, 382 P.2d 129 (Okla. 1963).

[19] Mass. Gen. Laws Ann. ch. 108A, §§ 29-43 (1958).

[20] Mass. Gen. Laws Ann. ch. 108A, §§ 13, 15 (1958).

[21] Under Mass. Gen. Laws Ann. ch. 156A, § 14 (Supp. 1963), there is a seventy-five dollar fee to be paid when filing the articles of organization. Mass. Gen. Laws Ann. ch. 156, §§ 47, 55 (1958), imposes a twenty-five dollar fee to be paid when filing the required certificate of condition at the end of the fiscal year. Also, the professional corporation must file an annual excise tax return, including any tax due, under Mass. Gen. Laws Ann. ch. 63, §§ 30-50 (1958).

profit sharing plans.[22] In *United States v. Kintner*,[23] it was held that an association of doctors possessed sufficient corporate characteristics to qualify as a corporation under the Internal Revenue Code. The association was thus able to provide an otherwise qualified pension plan for the doctor-employees, contributions to which were not taxable as compensation to the doctors. A qualified plan allows the corporation to deduct contributions made to such plans,[24] and the contributions made to the plan by the employer are not taxed to the employee until the time fixed for distribution.[25] In addition, income from the fund established under these plans is tax exempt.[26] The effect is to defer compensation until a time when the surtax is less onerous.

Pursuant to the *Kintner* decision, the Commissioner promulgated regulations formulating the tests and standards to be applied in determining qualification as a corporation for tax purposes.[27] The regulations emphasized that while the Code sets the standards for classifying an organization as a corporation, it is local law which determines whether these characteristics exist in fact. The regulations are concerned with the *Kintner* situation, *i.e.*, whether an *un*incorporated organization shall be classified as an association for federal tax purposes. Boris I. Bittker asserts, however, that to hold the regulations inapplicable because of the state "corporation" label is "question begging."[28] Professor Bittker contends that the regulations are valid standards for determining ". . . when a self-styled 'corporation' should be treated as such."[29] His thesis is that professional associations and corporations do not qualify as associations because the statutes creating them generally impose restrictions which prevent the corporation or association from meeting the standards imposed by the regulations.[30] To illustrate Professor Bittker's general approach, reference may be made to the requirement of centralization of management. The regulations state:

> An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions

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[22] Int. Rev. Code of 1954, §§ 401-04.

[23] 216 F.2d 418 (9th Cir. 1954).

[24] Int. Rev. Code of 1954, § 404 (a)(3).

[25] Int. Rev. Code of 1954, § 402 (a).

[26] Int. Rev. Code of 1954, § 501 (a).

[27] Treas. Reg. §§ 301.7701-1, 301.7701-2 (1960).

[28] Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1, 26 (1961).

[29] Id. at 27.

[30] Treas. Reg. § 301.7701-2(a)(3) (1960) states:

> An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics.

The characteristics referred to are outlined in Treas. Reg. § 301.7701-2(a)(I) (1960):

> (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.

necessary to the conduct of the business for which the organization was formed.[31]

As in the Georgia Act, which is used as an example by Professor Bittker, the Massachusetts statute does not refer to management or define its scope in the professional situation. However, section 11 of chapter 156A indicates that the professional is still responsible to the appropriate regulating board despite his corporate office, and the traditional responsibility of each professional to his patient or client is maintained by section 10. Professor Bittker questions whether there can be "continuing exclusive authority to make the management decisions for which the corporation was formed," *e.g.*, medicine, if the individual doctors cannot delegate their professional responsibilities to a fraction of their number. Professor Bittker concludes that there is at best a "loose kind of centralized management" under such conditions.

The above illustration indicates that there are doubts as to the feasibility of professionals obtaining corporate standing for tax purposes under the present regulations, and aspirations of qualifying will doubtlessly wane in view of the ominous reverberations of the Commissioner. The Commissioner has reacted to the rash of professional corporation and association statutes by proposing amendments to the present regulations.[32] The amendments appear to eliminate any possibility of achieving corporate status for tax purposes under the Massachusetts or other professional corporation statutes. With regard to the requirement of continuity of life, the proposed regulations require that it must exist without depending on an agreement of the members.[33] Section 13 of chapter 156A requires that purchase or redemption of shares of deceased or disqualified shareholders be provided for in the articles of organization or by-laws. Thus, there can be no incorporation without an agreement by the members as to the purchase or redemption, and it is likely that retention of corporate status would be contingent on the fulfillment of the "agreement" on death or disqualification of a shareholder.

The regulations adopt Professor Bittker's contention that a professional service organization cannot have centralization of management, as it exists in an ordinary business corporation, and still maintain ". . . traditional professional autonomy with respect to professional decisions and the traditional responsibility of a professional person to the client or patient."[34] Limited liability does not exist under the regulations if the liability of the professional person to his client or patient is greater than the personal liability of a shareholder-employee of an ordinary business corporation to its customers.[35] It may be argued that in many instances the liability of a professional person to patient or client is no greater than that of a shareholder-employee of an ordinary business corporation, especially where the latter is a close corporation and liability is for negligence occasioned by acts

[31] Treas. Reg. § 301.7701-2(c) (1960).

[32] Proposed Treas. Reg. §§ 301.7701-1(d), 301.7701-2(h), 28 Fed. Reg. 13750 (1963).

[33] Proposed Treas. Reg. § 301.7701-2(h)(2), 28 Fed. Reg. 13751 (1963).

[34] Proposed Treas. Reg. § 301.7701-2(h)(3), 28 Fed. Reg. 13751 (1963).

[35] Proposed Treas. Reg. § 301.7701-2(h)(4), 28 Fed. Reg. 13752 (1963).

performed in fulfilling the corporate purpose as, *e.g.*, a shareholder-truck-driver of a trucking corporation.

The discussion of free transferability in the regulations concludes with the rule that ". . . if a member of a professional service organization may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization, the corporate characteristic of free transferability of interests does not exist."[36] Section 7 of chapter 156A does not require that a shareholder give the other members of the organization the first opportunity to acquire his interest. However, it is probable that the by-laws would provide for "first opportunity" for the members of the organization. The regulations require that the transferring member be able "to confer upon his substitute all the attributes of his interest in the organization,"[37] *i.e.*, the right to practice, in order to have free transferability. The remaining members would undoubtedly want to restrict ingress into their organization, since personal qualities are so important to the success of a professional venture.

It is obvious that the proposed regulations are directed specifically at professional corporations and associations. The Commissioner's approach appears to have been to pick characteristics peculiar to such professional corporations and associations and to conclude that these characteristics are "essentially different in an ordinary business corporation."[38] While the conclusion assumes the argument, especially since close corporations may be very similar to the professional corporation by virtue of voting agreements and restrictions on transfers, it seems apparent that the Commissioner is bound to prevail. Professionals and other self-employed persons have been striving to achieve tax equality with the corporate employee, with respect to pension and profit sharing plans, for a number of years. Congress finally responded by enacting the Keough Bill (H.R. 10).[39] This bill amends the Internal Revenue Code of 1954, sections 401-404. The enactment allows the self-employed person to treat himself as both employer and employee, for purposes of the statute. The Keough Bill has not received a warm reception because of the limitations on contributions and deductions which do not apply to the ordinary corporate employee.[40] The lack of enthusiasm does not alter the fact, however, that Congress has seen fit to deal

[36] Proposed Treas. Reg. § 301.7701-2(h)(5)(ii), 28 Fed. Reg. 13752 (1963).

[37] Treas. Reg. § 301.7701-2(e)(I) (1960).

[38] This statement permeates the proposed regulations.

[39] Self-Employed Individuals Tax Retirement Act of 1962, 76 Stat. 809 (1962), 26 U.S.C.A. §§ 401-04 (1963).

[40] Generally, amounts which may be contributed on behalf of an owner-employee are limited to a maximum of $2,500 per year. The self-employed person is not as limited in the amount he may contribute for himself, but in both cases, 10% of earned income or $2,500, whichever is the lesser is the basis on which deductions are determined. Both are limited to a maximum deduction of ½ of $2,500. In addition, these plans must cover full time employees with a period of employment of three years or more. See *e.g.*, Rapp, The Self-Employed Individuals Tax Retirement Act of 1962, 18 Tax L. Rev. 351 (1963); Campbell, Self-Employed Individuals Tax Retirement Act of 1962, 32 Fordham L. Rev. 279 (1963).

with the tax situation of the self-employed, including professionals, under the Keough Bill. The congressional intent to limit tax privileges to the self-employed within the confines of the Keough Bill will be sure to protect the proposed regulations from vigorous attack.

From the foregoing analysis it would not be unreasonable to conclude that the *raison d'etre* of chapter 156A no longer exists. There are, perhaps, peripheral reasons for incorporating under this statute, but they are not obvious. The uniqueness of a professional corporation and the resultant lack of case law in the area, make it fertile ground for litigation, giving body to the statutory framework. It is improbable that many professionals will desire to embark on such an adventure in view of the limited benefits to be derived therefrom.

JOSEPH L. DE AMBROSE

TAXATION

THE TAXATION OF MUTUAL FUND SHAREHOLDERS

The increased number of relatively low income investors during the past decade has focused special attention on the open-end investment company, commonly called the Mutual Fund.[1] This is not to suggest that large investments are not made in Mutual Funds by individual shareholders, but, rather, implies one of the original objects of the Mutual Fund. Professional investment management simply cannot be afforded by investors whose holdings are not of a very substantial quantity. Investment consultants, furthermore, are not interested in handling small accounts because of the percentage fee basis on which they conduct business. The Mutual Fund was conceived as a means of providing professional management for all sizes of investments. To this end a relatively simple scheme was devised whereby investors contribute what they wish to the assets of the fund, receiving in return shares or certificates indicating the amount of their investments. All the assets of the fund are then turned over to investment managers who, for a fee, usually a fraction of a percentage, invest and dispose of the assets among securities according to the policies and purpose of the fund. The fund then passes along to its shareholders the income from its investments as well as its capital gains provided the latter are not reinvested. At any time the shareholder can "redeem" his shares; that is, cash them in for their net asset value which is computed twice daily by most funds. The plan is roughly analogous to an agency relationship between the fund and its shareholders although in this respect one crucial distinction is that the shareholder has no property interest in the securities purchased by the fund.

Because of the unique structure and purpose of the Mutual Fund, the fund and its shareholders are subject to special provisions in the tax laws which reflect the "conduit" nature of the fund. Earnings and profits of the

[1] For all practical purposes the distinction between open and closed-end investment companies is that the former will redeem its own shares.