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Advantages and Pitfalls for Texas Professional Corporations.

Leonard Leighton

Edgar M. Duncan

ADVANTAGES AND PITFALLS FOR TEXAS PROFESSIONAL CORPORATIONS

LEONARD LEIGHTON* AND EDGAR M. DUNCAN†

One of the most important developments in recent years involving practically all professions is the apparent availability of the corporate vehicle for performing their practice with the attendant benefits available through the corporate tax structure.

These benefits, as well as the disadvantages and potential tax pitfalls and the practical aspect of incorporating a professional practice, will be examined in this article.

For many years professionals have been unable to incorporate their practice with any assurance that their entity would be recognized as a corporation for federal income tax purposes. The Internal Revenue Service has consistently taken the position that by the very nature of the doctor-patient, attorney-client and other professional-client relationships, incorporation by these groups would be almost impossible to achieve because the necessary corporate characteristics would not be present.

CHANGE IN TREASURY POSITION

However, on August 8, 1969, the Internal Revenue Service published Technical Information Release 1019,[1] which conceded that under certain circumstances professionals could set up professional corporations or associations that would generally be treated as corporations for federal income tax purposes.

HISTORY OF TAX CONTROVERSY

To understand more clearly the circumstances under which corporate taxation will now be available to professionals, it is necessary to understand the history of this tax controversy, how it developed, and the circumstances under which this Technical Information Release was published.

In 1954, in *United States v. Kintner*,[2] the Service challenged the cor-

* Partner, Sawtelle, Goode, Troilo, Davidson & Leighton, San Antonio, Texas. B.B.A., LL.B., University of Texas; LL.M., (Taxation) New York University. Special Instruction Staff, St. Mary's University, School of Law.

† Associate, Sawtelle, Goode, Troilo, Davidson & Leighton, San Antonio, Texas; A.B., Washington and Lee University; J.D., St. Mary's University.

1 Technical Information Release 1019 (1962-2 CUM. BULL.). This was subsequently formalized in Rev. Rul. 70-101, I.R.B. No. 1970-9, March 2, 1970.

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

porate status of a group of doctors in Montana that had organized a "professional association" for the practice of medicine. Under the 1939 Code, which was in effect at that time,[3] and under current section 7701 (a)(3), the term "corporations" includes "associations." Montana law forbade physicians from actually setting up a corporation at that time.

The Ninth Circuit held that the "professional association" was taxable as a corporation because the association had the characteristics of a corporation. These characteristics were set forth by the United States Supreme Court in 1936 in *Morrissey v. Commissioner*.[4] The Supreme Court held that a business trust must be taxed as a corporation because the following factors made it "analogous to a corporate organization":

1. The entity held title to property.
2. The entity furnished the opportunity for centralized management.
3. The entity had continuity of life.
4. There was free transferability of the entity's shares.
5. There was limitation of liability.

As a result of the *Kintner* case, the Service issued new regulations that sought to deny professionals the victory they had won in *Kintner*. These regulations set forth corporate characteristic requirements that under state law at that time would have been almost impossible for professional associations to meet.[5]

Under these regulations, adopted by the Treasury in 1960, the following characteristics would distinguish a corporation from other entities:

1. Continuity of life,
2. Centralization of management,
3. Limited liability,
4. Free transferability of interests,
5. Associates, and
6. Objective to carry on a business and divide the gains therefrom.

The Regulations stated specifically that any entity "subject to a state statute corresponding to the Uniform Partnership Act" cannot possess the first three characteristics, and state law was to be the determining factor as to whether these characteristics were present. The various

[3] INT. REV. CODE of 1939, § 3797(a)(3).
[4] 296 U.S. 344, 56 S. Ct. 289, 80 L. Ed. 263 (1935).
[5] TREAS. REG. § 301.7701-2(a)(1), T.D. 6503, 1960-2 CUM. BULL. 409.

state legislatures met this challenge by enacting Professional Corporation and Professional Association statutes designed specifically to provide these professional organizations with sufficient characteristics to qualify under the 1960 Regulations. In all, some 47 states enacted legislation specifically providing for some form of professional corporation or association statute that would give professionals the necessary vehicle to raise them to corporate tax status.[6]

The Treasury struck back in 1965 by amending its Regulations to such an extent that it would be impossible for a professional organization to meet its qualifications even under the new state statutes. In effect, Treasury Revenue Regulation section 301.7701-2, as amended, provided that a professional corporation will not be recognized as a corporation for federal income tax purposes. The Service instructed its personnel to set up for audit and review every tax case involving professional associations or corporations and required them to deny corporate tax treatment.

The only resort the professional had was the courts, and in every case where the taxpayer challenged the Treasury position, he was upheld by the courts. However, as a practical matter, the cost of litigating the issue with the Service in each case was a sufficient deterrent to almost all professional practitioners who wanted to incorporate.

Then, on May 27, 1969, the Fifth Circuit rendered its decision in *Kurzner v. United States.*[7] The Fifth Circuit held that Gregory Orthopedic Associates, a Florida professional association, was a corporation for federal income tax purposes. This was the same conclusion reached by two other circuits, the Tenth and Sixth Circuits in *United States v. Empey*[8] and *O'Neill v. United States,*[9] and it represented the fourteenth straight victory for the taxpayer against the Treasury.[10] All three circuits held that the 1965 Treasury Amendments to the Regulations were invalid.

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[6] *See* Hall, Gissel and Blackshear, *Professional Incorporation in Texas—A Current Look,* 48 TEXAS L. REV. 84, 92 (1969).

[7] 413 F.2d 97 (5th Cir. 1969).

[8] 406 F.2d 157 (10th Cir. 1969).

[9] 410 F.2d 888 (6th Cir. 1969).

[10] O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); United States v. Empey, 406 F.2d 157 (10th Cir. 1969); Smith v. United States, 301 F. Supp. 1016 (D.C. Fla. 1969); National Bank and Trust Co. v. United States, — F. Supp. — (N.D. Okla. 1969); Cochran v. United States, 299 F. Supp. 1113 (D.C. Ariz. 1969); Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968); Fowler v. United States, — F. Supp. — (N.D. Ohio 1969); Kelsey v. United States, — F. Supp. — (D.C. Ark. 1969); Van Epps v. United States, 301 F. Supp. 256 (D.C. Ariz. 1969); Ahola v. United States, 300 F. Supp. 1055 (D.C. Minn. 1969).

SERVICE PUBLISHES TIR 1019

As a result of these decisions against the government, the Service on August 8, 1969, published Technical Information Release 1019, which conceded that professional associations would generally be treated as corporations for tax purposes. In the meantime the Texas Legislature, with perfect timing, had passed a Professional Association Act,[11] which became effective on June 18, 1969, and a Professional Corporation Act,[12] which became effective on January 1, 1970. These Acts provide the statutory vehicle for corporate tax treatment of Texas professionals.

SIGNIFICANCE OF TIR 1019

While TIR 1019 can be looked upon as a significant victory for the taxpayer, it should by no means be taken as a complete surrender by the Service. In the February, 1970 issue of the *Journal of Taxation*, Mr. K. Martin Worthy, Chief Counsel of the Internal Revenue Service and a participant in the decision to issue TIR 1019, stated, "while we accept the conclusion of the courts that the 1965 amendments are invalid, we do not accept the suggestion of *O'Neill* and *Empey* that a state label will suffice even if the organization lacks all the traditional corporate characteristics. Certainly, such a conclusion should not be read into the TIR."[13]

In both *Empey* and *O'Neill*, the Tenth and Sixth Circuits placed heavy emphasis on the fact that under state law both entities met the state prerequisites of a corporation. There was no examination for purposes of determining whether the characteristics of a corporation as previously defined in *Morrissey* and *Kintner* were present. The Fifth Circuit, in reaching its decision in *Kurzner*, found that the necessary corporate characteristics were present and upheld the taxpayer's claim for corporate tax treatment on that basis. It is clear from Technical Information Release 1019 and Mr. Worthy's statement that the Service will continue to examine in each case the factual circumstances of the organization to determine the existence of these corporate characteristics. If they do not exist, they would not be granted corporate tax treatment even if they were determined to be a corporation under state law.

Thus, it is important to organize the professional corporation or

11 TEX. REV. CIV. STAT. ANN. art. 1528f, §§ 1-24 (Supp. 1969).
12 TEX. REV. CIV. STAT. ANN. art. 1528e, §§ 1-20 (Supp. 1969).
13 Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. OF TAXATION 88 (1970).

association in such a manner as to provide it with as many corporate characteristics as are possible under the particular circumstances of each case. It was indicated in TIR 1019 that appropriate modifications of existing regulations would be issued consistent with these recent decisions and that the Legislation and Regulations Division of the Treasury is currently reviewing the Regulations in an effort to provide taxpayers and the government with guidelines to follow for the future. It will, of course, be extremely important to keep a watchful eye for these regulations and follow them where possible.

In the meantime, for those who want to move forward with the organization of professional corporations and associations, the organization should basically be organized and run like any other corporation. A board of directors and slate of officers must be elected, and the Texas Acts provide that all officers, directors and shareholders must be licensed to render the professional services offered by the corporation. Director and shareholder meetings must be held at least annually, and all the formalities of corporate organization should be diligently exercised.

The name of the professional organization should appear on all firm stationery, cards, statements for services rendered, and other corporate materials. Written employment contracts should be executed between the organization and all shareholder-employees.

In *Kurzner v. United States* the Fifth Circuit stated:

> Whether or not GOAPA has "centralized management," its offices are most certainly centrally operated. All stationery used by it bears its name. It maintains a bank account from which all disbursements relating to its business are made and its accounting records are centralized in its name. All bills are issued in its name and all payments are made directly to it. The doctor-employees receive no direct fees and no separate record is kept of the number of patients treated by a particular doctor.[14]

The importance of following through on all these matters and in making sure that the corporate characteristics are present was emphasized in a recent tax court case where the tax court pierced the corporate veil of a group of radiologists who were using the corporate form more or less as a conduit.[15] In this case four doctors formed a professional service corporation under Wisconsin law. Each doctor continued to engage in his individual practice; and although income generated from their services was deposited in the corporate checking

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[14] 413 F.2d 97, 99 (5th Cir. 1969).
[15] Jerome J. Roubik, 53 T.C. 36 (1969).

account, each doctor was charged with his individual expenses and received substantially all the income attributable to his services. The tax court held that each physician continued to treat his own practice separately from the other shareholders rather than through the corporation as a true business entity. The corporate form was thus disregarded and the professionals were denied corporate tax treatment.

ONE-MAN CORPORATIONS OR ASSOCIATIONS

In TIR 1019, the Treasury reserved the right to refuse corporate tax treatment in cases where the facts were not similar to *O'Neill* and *Kurzner*. In both of these cases more than one professional was involved and one corporate characteristic the Treasury has always examined in these cases is the presence of "associates." There has been considerable speculation that the Treasury will require more than one professional to be involved in a professional association or organization to qualify for corporate tax treatment. However, in Mr. Worthy's article he stated:

> Over one-fourth of the state statutes permit professional organizations to have one shareholder and one director who is such shareholder, but we have concluded that such a provision in and of itself will not serve to deny corporate classification.[16]

Under both the Texas Professional Corporation Act[17] and the Texas Professional Association Act[18] one person can set up a professional corporation or association. After January 1, 1970, doctors of medicine may use the Texas Professional Association Act but may not use the Texas Professional Corporation Act.[19] Doctors of medicine were specifically omitted from the Professional Corporation Act at the urging of the Texas Medical Association because it felt that the inherent relationship between doctor and patient should not be practiced through a

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[16] Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. OF TAXATION 88 (1970).

[17] TEX. REV. CIV. STAT. ANN. art. 1528e, § 4 (Supp. 1969).

[18] TEX. REV. CIV. STAT. ANN. art. 1528f, § 2(A) (Supp. 1969).

[19] TEX. REV. CIV. STAT. ANN. art. 1528e, § 3(a) (Supp. 1969); TEX. ATT'Y GEN. OP. NO. M-551 (1970) states:

> After the effective date, [of] (*sic.*) the Texas Professional Corporation Act (Senate Bill 589), the only professional service which is not permitted to be performed by a corporation is the professional services rendered by individuals licensed by the Texas State Board of Medical Examiners. In view of the provisions of Section 3 of Senate Bill 745 (Professional Association Act), it is our opinion that after January 1, 1970, the effective date of the Professional Corporation Act, the Professional Association Act applies only to individuals licensed by the Texas State Board of Medical Examiners. Our conclusion follows the fact that after January 1, 1970, any profession except the practice of medicine, can be incorporated and the services can by law be performed by a corporation.

"pure" corporate entity. The Texas Medical Association decision in this regard may prove to be the undoing of any attempt by a one-man medical practitioner to secure corporate tax treatment. The Treasury is likely to take the position that a necessary ingredient to organizing a professional association is associates—an ingredient obviously lacking in a one-man association. However, it is very possible that these one-man practitioners and their advisors will be creative enough to solve this problem through working arrangements with other medical practitioners.

Mr. Worthy's statement in his article, plus the fact that there are no restrictions on one-man shareholder ownership of other business corporations, seems to reduce any problem of recognition of the existence of a one-man professional corporation under a Professional Corporation Act.

Other Problems of One-man Corporation

In any event, it is clear that the one-man association or corporation will have more problems to contend with than other professional organizations in its actual operation. One such problem is the possibility of having the corporation or association treated as a personal holding company. Under section 541 of the Code[20] a personal holding company is taxed at a rate of 70 per cent on its undistributed personal holding company income. A corporation may be treated as a personal holding company if more than half of its stock is owned by five or fewer individuals, and 60 per cent of its gross income comes from among other categories "personal service contract income."[21] Personal service contract income is an amount received under a contract under which the corporation is to furnish personal services, if some other person than the corporation has the right to designate the individual who is to perform the services, or if such individual is designated in the contract, provided that the individual designated owned, at some time during the year, 25 per cent or more of the corporation's stock.[22] This provision will present no problem in cases where a client retains the professional corporation as such and the corporation chooses the particular person who will perform services for the client. However, in a one-man professional corporation it could be argued by the Service that the hiring of the corporation by the client or patient was in effect the designation

20 INT. REV. CODE of 1954, § 541.
21 INT. REV. CODE of 1954, § 542(a).
22 INT. REV. CODE of 1954, § 543(a)(7).

of that individual to perform the service. Of course, if all the earnings of the one-man professional organization are distributed by the organization to its shareholder, there would be no personal holding company problem. In other words, the tax will not apply if the professional organization pays out all its income year by year to its shareholder.

Section 482 Problem

Another problem that the one-man association or corporation might face is that the government might argue under section 482 of the Code that income should be attributed directly to the person whose services produced it.[23] Under this argument, all income to the one-man entity would be taxed directly to the individual who earned the income and the corporation would be bypassed completely. Until the Regulations are issued, it is not clear what the Service's position will be with regard to the application of section 482.

BENEFITS OF INCORPORATING

After analyzing some of the problems involved in incorporating, the obvious question is: Is it worth it? Why should I incorporate? As the tax law has developed over the years, certain fringe benefits were made available to "employees" as opposed to "owners" of a particular business or profession. These so-called fringe benefits have made it very attractive to become an employee as opposed to being considered an owner. When a professional incorporates his practice he will become an employee of his corporation and many of these benefits previously unavailable to him as an owner become available in his new capacity as an employee.

Pension and Profit Sharing Plans

At the present time, a self-employed person can participate in a self-employed pension or profit sharing plan, commonly called *HR 10* or the *Keough Plan*.[24] The benefits available to the self-employed under such a plan are restricted and limited to a far greater extent than those

23 INT. REV. CODE of 1954, § 482, provides as follows:
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

24 INT. REV. CODE of 1954, §§ 401-404.

available to an employee under a regular corporate pension or profit sharing plan. For example, under the self-employed plan, the maximum annual contribution of the self-employed individual is limited to $2,500.00 or 10 per cent of his compensation, whichever is lower.[25] Under a corporate profit sharing plan, the maximum contribution is 15 per cent of the employee's compensation.[26] Contributions to a qualified plan are deductible by the corporation and do not have to be reported as income by the participants in the plan until withdrawn by them at retirement or when the benefits are otherwise made available to them.[27] The earnings of a qualified pension or profit sharing trust are exempt from federal income tax thus allowing the trust to increase in value without the burden of paying taxes annually.[28]

Under section 2039(c) of the Internal Revenue Code of 1954, death benefits under a corporate plan are exempt from federal estate taxes to the extent they are attributable to the employer's contributions, and the proceeds are not payable to the deceased employee's estate. This estate tax exemption is not available under a self-employed plan.

Prior to enactment of the 1969 Tax Reform Act, the distribution in one taxable year of the total benefits to an employee under a regular pension or profit sharing plan received capital gain as opposed to ordinary income treatment. This favorable treatment has never been available to participants in a self-employed plan. The 1969 Act reduced this advantage of the corporate plan by withdrawing capital gain treatment from that part of the lump sum distribution that represents contributions from the employer. However, this advantage is still very important because capital gain treatment is still available to that part of the distribution representing contributions to the plan by the employee and the appreciation of, and earnings on, all investments of the qualified trust.[29]

There is still no capital gain treatment on a lump sum distribution to a participant in a self-employed plan.[30]

In addition, there are other limitations on benefits and restrictions specifically applicable to owner-employees that would not be applicable to the same person if he were an "employee" under a corporate plan.[31]

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[25] INT. REV. CODE of 1954, § 404(e).
[26] INT. REV. CODE of 1954, § 404(a)(3).
[27] INT. REV. CODE of 1954, § 402(a).
[28] INT. REV. CODE of 1954, § 2039(c).
[29] TAX REFORM ACT of 1969, PUB. L. NO. 91-172, § 515 *amending* INT. REV. CODE of 1954, §§ 402(a), 403(a)(2) and 72(n).
[30] INT. REV. CODE of 1954, § 402(a).
[31] INT. REV. CODE of 1954, § 401(d) and § 401(e).

Group Term Life Insurance

The corporation can take out a group term life insurance policy on the life of its employees and the cost of up to $50,000.00 of such insurance on each employee would be deductible by the corporation and under section 79 of the Internal Revenue Code, would not be taxable as income to the employee.[32] These benefits are not available to the self-employed.

Health and Accident Plan

The corporation can deduct contributions to accident or health plans for the benefit of its shareholder—employees and their dependents, or it may actually reimburse them for medical expenditures without these payments constituting taxable income to them under section 105 of the Internal Revenue Code.[33]

Section 105 specifically provides that the term "employee" does not include a self-employed individual.[34] The self-employed are required to treat the premiums for hospitalization and medical insurance as medical expenses, the deductibility of which is limited under section 213 of the Internal Revenue Code.[35]

Death Benefits

The corporate employer can provide a death benefit of up to $5,000.00 for the deceased employee's estate or beneficiary and this amount would not be taxable income under section 101 of the Internal Revenue Code.[36] No comparable provision is available to the self-employed.

Lower Tax on Corporate Income

Without considering the 2.5 per cent tax surcharge, which is scheduled for expiration on June 30, 1970, the corporate tax rate is 22 per cent on its first $25,000.00 of income with a surtax of 26 per cent on all income above $25,000.00. Thus, all income of a corporation below $25,000.00 will be taxed at a 22 per cent rate and income above $25,000.00 will be taxed at a maximum rate of 48 per cent.[37] This compares favorably with the maximum individual tax bracket of 70

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32 INT. REV. CODE of 1954, § 79(a).
33 INT. REV. CODE of 1954, § 105.
34 INT. REV. CODE of 1954, § 105(g).
35 INT. REV. CODE of 1954, § 213(a) and § 213(b).
36 INT. REV. CODE of 1954, § 101(b).
37 INT. REV. CODE of 1954, § 11.

per cent. Some relief to the professional practitioner has been provided in the 1969 Tax Reform Act with regard to the maximum tax on his earned income. The Act added new Code section 1348, which provides for a maximum marginal rate for earned income of 60 per cent in 1971 and 50 per cent thereafter, as contrasted with dividends, interest, rents and other passive income which continue to be taxed at the existing maximum bracket of 70 per cent.[38] The regular rates on joint returns exceed 50 per cent beginning with $52,000.00 of taxable income and it is at this level of earned income that the new Act will provide some relief.

The enactment of section 1348 does not mean, however, that corporate taxation will lose most of its lower tax rate attractiveness. Assume, for example, a doctor whose adjusted gross income is $48,000.00. Assuming that he files a joint return, his tax bracket would be 50 percent and his tax bill, excluding the surcharge, would be $16,060.00.

If the doctor did not personally need all his earnings from his profession and wanted to build a new clinic, he could, through incorporation, retain in the corporation up to $25,000.00 annually for purposes of having the corporation build the clinic. His personal tax would then be reduced to $5,340.00 and the corporation would pay $5,500.00 in corporate taxes for a total outlay of $10,840.00 or a reduction in current year's taxes of $5,220.00. This savings in taxes of over $5,000.00, plus the $25,000.00 retained by the corporation could then be utilized for purposes of building the new clinic.

Of course, the $25,000.00 has been left in the corporation and if the shareholder attempts to withdraw the funds later, he may have dividend problems. However, the earnings should not be left in the corporation unless the professional is reasonably sure that the retained funds will not be needed currently by him and will be utilized by the corporation in such a manner as will be beneficial to him. If the professional does not want to leave any retained earnings in the corporation he can, of course, have the corporation pay him a reasonable salary. There should generally be no problem with regard to a professional corporation being able to distribute all its earnings to its professional shareholders.

The professional cannot let his corporation accumulate more than $100,000.00 of retained earnings without having some good reason for the retention.

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38 TAX REFORM ACT of 1969, PUB. L. NO. 91-172, § 804 *adding to* INT. REV. CODE of 1954 § 1348.

Under section 531 of the Internal Revenue Code there can be an accumulated earnings tax of up to 38.5 per cent of the accumulated taxable income, if the accumulated earnings of the corporation exceed $100,000.00, and if the corporation does not have a reasonable need for the accumulated earnings.[39] The accumulation of funds for purposes of building a new clinic or office building should meet this reasonable need requirement.

Ease of Transferring Ownership at Capital Gain Rates

Generally, the tranfer of stock is easier to accomplish than the transfer of a partnership interest and involves fewer tax problems. With a professional corporation, this is limited to a sale to another professional in the same field, but the advantage here is that a sale of part or the entire interest in the enterprise will be taxed at capital gain rates. This removes the problem of possible ordinary income treatment to the transferor upon the transfer of unrealized receivables and inventory when a new partner is brought into the firm.

Fiscal Year Selection

The organization of a professional corporation provides a very important opportunity for the professionals involved to select a fiscal year other than a calendar year without the necessity of securing the Internal Revenue Service's permission.

NON-TAX ADVANTAGES

In addition to the tax advantages, there are non-tax advantages which should be considered.

Centralization of Management

The larger the organization the more important some kind of centralized management becomes. Certainly the corporate organization affords a more effective entity in the daily management of a sizeable concern.

Limited Liability

Under the Texas Professional Corporation Act, there would be no limited liability as between the professional and his patient or client.[40] There would, however, be some degree of limited liability in that, as

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39 INT. REV. CODE of 1954, § 531(a).
40 TEX. REV. CIV. STAT. ANN. art. 1528e, § 16 (Supp. 1969).

between the professional and the creditors of the corporation, the protection of the Texas Business Corporation Act would be present.

In Mr. Worthy's article in the *Journal of Taxation*, he stated that the Texas Professional Corporation Statute might have retained complete joint and several liability and voiced concern by stating "and these provisions trouble me, though I am not prepared to say that this alone will be enough to disqualify an organization formed under the statute."[41] It is apparent, however, from section 16 of the Texas Professional Corporation Act that there is not complete joint and several liability as between all of the shareholders. Section 16 merely provides that "the corporation shall be jointly and severally liable for such professional errors, omissions, negligence, incompetence, or malfeasance on the part of any officer or employee thereof" and does not make all shareholders jointly and severally liable for such acts. This should provide sufficient limited liability to meet this corporate characteristic test.

Continuity of Existence

Under a corporate structure it would be much easier for shareholders to withdraw from the organization or transfer a portion of their interest to others in relation to tranfer of such interests under a partnership arrangement. There would be no serious problem of dissolution or interruption of the organization upon the death or divorce of one of the principals, and it would be easier to bring in associates through stock purchases and control of the corporation could be maintained through the issuance of voting and non-voting stock.

SUB-CHAPTER S ELECTION

In analyzing whether a professional corporation or association should be organized, the availability of Sub-Chapter S of the Internal Revenue Code should not be overlooked.[42] Briefly, an election under Sub-Chapter S of the Code would generally eliminate taxation of the corporation and the double taxation or dividend problem, as the income of the corporation would be taxed directly to its shareholders. It would also remove any question of unreasonable compensation, unreasonable accumulation of earnings by the corporation and the personal holding company problem.

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41 Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. OF TAXATION 88 (1970).
42 INT. REV. CODE of 1954, §§ 1371-1379.

Generally, most professional service corporations could qualify under Sub-Chapter S if they had less than 10 shareholders and issued only one class of stock.[43] Election of Sub-Chapter S treatment would have to be made within the first month the organization begins business, or within one month after the start of any subsequent fiscal year.[44] Before any Sub-Chapter S election is made, however, certain disadvantages should be considered. The Tax Reform Act of 1969 denies certain benefits of qualified pension and profit sharing plans to Sub-Chapter S corporations that would otherwise be available to a professional corporation.[45]

Basically, the 1969 Act limits the benefits to be derived from a pension and profit sharing plan to those available to the self-employed under an *HR 10* plan with certain modifications. An attempt was made to apply similar restrictions on qualified pension and profit sharing plans of "pure" professional corporations, but these restrictions were removed by a vote of 65 to 25 on the Senate floor, after the restrictions were approved by the Senate Finance Committee. It is anticipated that the Treasury will continue to push for tighter restrictions on pension and profit sharing plans of professional corporations, so the last chapter probably has not been written on this subject.

In the meantime, those who set up a professional corporation with an eye toward obtaining the maximum in pension and profit sharing benefits should forget about electing Sub-Chapter S.

Practical Problems in Incorporating

Once the decision has been made to incorporate, care should be taken to make sure that no problems are created in transferring the assets to the new corporation.

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43 INT. REV. CODE of 1954, § 1371(a).

44 INT. REV. CODE of 1954, § 1372(c).

45 TAX REFORM ACT of 1969, Pub. L. No. 91-172, § 531 *adding to* INT. REV. CODE of 1954, 91-172 § 1379. Under the Tax Reform Act of 1969, a "shareholder-employee" of a Sub-Chapter S Corporation must include in his income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his compensation or $2,500.00, whichever is less. These are the limitations applicable under a self-employed plan. However, the consequences of violating the 10 percent or $2,500.00 contribution limitation are not the same. If an excess contribution is made under a self-employed plan on behalf of an owner of more than a 10 percent interest, the excess contribution must be refunded to the owner and if it is not then the entire plan could be disqualified. If the contribution limitation is exceeded in the case of a contribution on behalf of an owner of 10 percent or less, the excess contribution is not deductible but it need not be refunded. Under the Tax Reform Act, if a Sub-Chapter S Corporation exceeds the contribution limitations on behalf of an employee with a stock interest greater than 5 percent, then the excess is included in his gross income but the funds can be left in the trust to grow without being subject to income tax liability and the corporation would receive a deduction for the entire amount of the contribution. If the employee has a 5 percent or smaller interest, then the 10 percent or $2,500.00 limitations would not be applicable to him.

Generally, a professional or group of professionals would suffer no tax consequences as a result of transferring whatever tangible or intangible assets are necessary to continue to carry out their practice in corporate form. Section 351 of the Internal Revenue Code provides in general that:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange, such person or persons are in control (as defined in Sec. 368c) of the corporation.

Control is defined in section 368c as ". . . the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the Corporation." If more than one individual is involved in the transfer to the corporation, care should be taken that the transfer of assets will be done in one transaction by all individuals so the 80 per cent control requirement will be met.

Under section 362 of the Code, the corporation would generally take the same basis in the assets transferred to it as held by the individual transferor. Each professional so transferring his assets to the professional corporation would take a basis in his stock equal to his basis in all his assets transferred to the corporation.

There has been some question as to what effect the transfer of unrealized receivables by a cash basis taxpayer to his new professional corporation would have on the transferor. Most professionals are on a cash basis and one of his largest assets is accounts receivable. Some writers have voiced concern that upon transfer of the receivables to the corporation by a cash-basis professional, the government might take the position that section 351 does not offer any protection to the taxpayer and the receivables should be taxed to the transferor under assignment of income principles.

Another theory is that the receivables might be taxed to the transferor professional under section 482 under principles that income should be taxed to the one who actually earned it. Mr. Worthy has stated:

> It would seem that the basic policy of Section 351 is to recognize that the new corporation represents a substantial continuation of the business formerly conducted by the transferor. This policy

would suggest that the transferor should not be taxed on accounts receivable and the new corporation should be taxed when it collects them. It is generally the practice of the Service to issue rulings to this effect in cases of a bona fide transfer of a going business to a new corporation, which is not carried out in such a way as to cause a distortion of income. It has also been the position of the Service to issue such rulings only if accompanied by closing agreements, which require as a condition to non-recognition by the transferor, that the transferee corporation agree that it will recognize income upon collecting receivables, and that such income would be ordinary in character if it would have been ordinary in the hands of the transferor.[46]

A question has also been raised as to whether the corporation could take a deduction when it actually pays liabilities of the individual professionals after they are transferred to the corporation where the transferor was on a cash basis and had not taken a tax deduction for the payables. It might be argued that the corporation cannot deduct them because its assumption of these liabilities is a capital cost. Under this theory, neither the transferor nor transferee would receive a tax deduction when payment was actually made. Mr. Worthy has indicated that the Treasury's position would be that a deduction to the corporation would be allowed if the transferor could have deducted the payment if he had paid it directly himself and there was no distortion of income.[47]

Thus, as far as accounts receivable and payables are concerned, there should be no problem on their transfer if the corporation treats them the same as the transferors would have been required to treat them if they had not been transferred to the corporation, and all the assets and liabilities connected with the professional's practice are transferred in the transaction.

Possible Application of Section 269

A question has also been raised as to the applicability of section 269 to the formation of a professional corporation or association. Basically, section 269 provides that if any person should acquire control of a corporation and the principal purpose of such acquisition was evasion or avoidance of federal income tax by securing a deduction, credit, or

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[46] Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. of Taxation 88, 90 (1970).

[47] Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. of Taxation 88 (1970).

other allowance which such person or corporation would not otherwise enjoy, then the Service may disallow such deduction, credit or other allowance. The Service might take the position that the only reason the corporation was organized was to take advantage of the corporate pension or profit sharing benefits or secure lower corporate tax rates.

If this argument were successful, then any person who organized a corporation for any business would probably be guilty of the same intent. It is not too surprising that Mr. Worthy stated:

> . . . even assuming that in a given case it did appear that a corporation was organized principally for the purpose of taking advantage of Code provisions relating to qualified pension and profit sharing plans, there is some question whether such a purpose would constitute "evasion or avoidance" of taxes for purposes of Section 269. These Code provisions do, after all, represent a deliberate granting of tax benefits to employers and employees. In IT 3757, 1945, CB 200, a case presenting a possibly analogous question, the Service ruled that the creation of a new corporation for the purpose of attaining the benefits of Code provisions relating to Western Hemisphere Trade Corporations did not constitute tax avoidance within the meaning of Section 269.[48]

CONCLUSION

Before anyone actually organizes a professional corporation they should recognize or be aware of the fact that this whole area of the law is still undergoing development, and no definite idea of the Treasury's position on professional corporations will be known at least until its regulations are issued. Even then, the corporate pension and profit sharing benefits now apparently available to these corporations may evaporate through new amendments to the Code. The Treasury will continue to push for legislation that will restrict these benefits to those now currently being enjoyed by the self-employed although indications are that the Congress will not consider their proposals this year. As to how successful the Treasury will be in their efforts, one can only take hope from the 65 to 25 vote in the Senate against their proposal.

[48] Worthy, *IRS Chief Counsel Outlines What Lies Ahead For Professional Corporations*, 32 J. OF TAXATION 88, 90 (1970).