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SELECTED PRACTICAL PROBLEMS WITH PROFESSIONAL ASSOCIATIONS AND PROFESSIONAL CORPORATIONS

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For several years doctors, lawyers, accountants, and other professionals have sought the tax advantages of practicing under the corporate form. In 1969 the Internal Revenue Service (IRS) reversed its policy of total opposition to the use of the corporate form by professionals.[1] In the same year of this realignment of Treasury policy the Texas Legislature passed the Texas Professional Corporation Act[2] and the Texas Professional Association Act.[3] Many Texas professionals have taken advantage of the policy change and the new legislation and have incorporated. Experience indicates that the advantages of the corporate form are substantial and that other professionals should consider using it. Many problems which are associated with professional corporations[4] have been uncovered by this experience. This article will identify and discuss several of the problem areas and propose some solutions.

Most of these problems encountered by professionals who incorporate are similar to those encountered by small, closely held business corporations. The significance and importance of these problems, however, is magnified in professional corporations for two reasons. First, while the IRS has dropped its total opposition to the concept of a professional corporation,[5] the history of its treatment of professionals seeking corporate tax benefits indicates that the IRS will continue to scrutinize these problem areas more closely when dealing with professional corporations than when dealing with small

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1. *See* Rev. Rul. 70-101, 1970-1 C.B. 278, *superseding*, Technical Information Release 1019, 1969-2 C.B.
2. TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 1978).
3. *Id.* art. 1528f.
4. Entities formed under the Texas Professional Corporation Act and the Texas Professional Act will be called professional corporations in this article.
5. Rev. Rul. 70-101, 1970-1 C.B. 278, *superseding*, Technical Information Release 1019, 1969-2 C.B.

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business corporations.[6] Secondly, the personal nature of professional practice, the independent judgment and action required by professionals, and the ease with which professionals confuse the corporate entity with themselves increase the difficulties in observing and maintaining the corporate form. The problems encountered when dealing with professional corporations generally break down into two broad categories — problems in formation and organization and problems in operation.

FORMATION AND ORGANIZATION

Incorporation

In Texas, professionals seeking to incorporate must do so under either the Professional Corporation Act,[7] the Professional Association Act,[8] or the Business Corporation Act,[9] whichever is applicable. Each professional group is covered by one of the acts and may not incorporate under any other act.[10] The Professional Association Act is applicable solely to osteopaths, physicians, surgeons, and other doctors of medicine licensed by the Texas State Board of Medical Examiners.[11] The Professional Corporation Act applies to most other persons who render professional services and who must obtain a license, or other legal authorization from the state, if such professional services were forbidden to be performed by a corporation prior to the passage of the Professional Corporation Act.[12] Additionally,

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6. *See* Treas. Reg. § 301.7701-2(a), T.D. 6503, 1960-2 C.B. 409. *See generally* L. DORIN, THE AMERICAN WAY OF TAXATION: INTERNAL REVENUE 1862-1963 at 104-05 (1963).

7. TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 1978).

8. *Id.* art. 1528f.

9. *See* TEX. BUS. CORP. ACT. ANN. art. 2.01 (Vernon Supp. 1978). The Business Corporation Act applies to all professional corporations on matters not covered by the Professional Corporation Act or the Professional Association Act. *See* TEX. REV. CIV. STAT. ANN. art. 1528e, § 5 & art. 1528f, § 25 (Vernon Supp. 1978).

10. *See* TEX. REV. CIV. STAT. ANN. art. 1528e, § 3a (Vernon Supp. 1978); TEX. ATT'Y GEN. OP. NO. M-551 (1970). *See generally* Leighton & Duncan, *Advantages and Pitfalls for Texas Professional Corporations,* 2 ST. MARY'S L.J. 11, 16-17 (1970).

11. *See* TEX. REV. CIV. STAT. ANN. art. 1528e, § 3a (Vernon Supp. 1978); TEX. ATT'Y GEN. OP. NO. M-551 (1970). *See generally* Leighton & Duncan, *Advantages and Pitfalls for Texas Professional Corporations,* 2 ST. MARY'S L.J. 11, 16-17 (1970).

12. TEX. REV. CIV. STAT. ANN. art. 1528e, § 3(a) (Vernon Supp. 1978); *see, e.g.,* TEX. ATT'Y GEN. OP. NOS. H-442 (1974)(registered public surveyors), M-1185 (1972)(podiatrist), M-556 (1970)(certified public accountants); TEXAS SECRETARY OF STATE, FILING GUIDE FOR CORPORATIONS AND LIMITED PARTNERSHIP INSTRUMENTS 32 (1974)(attorneys, accountants, dentists, veterinarians, psychologists, optometrists, and licensed and registered nurses).

a few professionals are authorized to incorporate under the Business Corporation Act.[13]

Expenses

No matter which act covers his services, the professional soon discovers that forming a professional corporation is moderately expensive initially. In order to receive the counseling necessary to properly analyze his needs and to create and establish a corporation, the professional will incur attorney's and accountant's fees. A filing fee also will be charged by the Secretary of State for issuing the Certificate of Incorporation or Association.[14] In subsequent years the corporation will incur additional expenses. Legal fees will continue to be incurred because keeping detailed corporate minutes and other instruments are necessary to keep the professional corporation functioning as a true corporation. If an attorney attends meetings and assists in the determination of bonuses, retirement plan contributions, and revisions of employment contracts, the fees incurred annually may be substantial. Preparation of an annual corporate income tax return will result in additional accounting fees. Further, employment taxes will be higher as the professional will typically be an employee of his corporation, which will be required to pay rising social security, unemployment insurance taxes, and workmen's compensation premiums on both professional and nonprofessional employees.[15] Additionally, if the corporation distributes any earnings and profits as dividends, the income will be subject to double taxation, once at the corporate level and again when realized by the shareholder.[16]

13. *See* TEX. REV. CIV. STAT. ANN. art. 1528e, § 5 & art. 1528f, § 25 (Vernon Supp. 1978). For example, licensed professional engineers have been able to practice as corporations organized under the Business Corporation Act. TEX. ATT'Y GEN. OP. NO. M-539 (1969). Paradoxically, despite being named in the statute as an example of a profession covered by the Professional Corporation Act, architects may not incorporate under the Act, but must be organized under the Business Corporation Act. TEX. ATT'Y GEN. OP. NO. M-551 (1970).

14. *See* TEX. REV. CIV. STAT. ANN. art. 1528f, § 22(1) (Vernon Supp. 1978)($50 for professional association); TEX. BUS. CORP. ACT ANN. art. 10.01A(1) (Vernon Supp. 1978) ($100 for professional corporation).

15. *See generally* W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 463-65 (1971).

16. A corporation is not entitled to any deduction for dividends paid, and dividends received are taxable to the shareholders. *See* I.R.C. § 61(a)(7). While it is true that an election to be taxed under subchapter S of the Internal Revenue Code would avoid problems such as double taxation, reasonable compensation, unreasonable accumulation of earnings, and personal holding company income, subchapter S corporations cannot advantageously use the

Transfer of Assets and Section 351

If the professional is just beginning his practice and will be transferring only cash to the corporation, the problems are minimal. Typically, there should be no tax consequences. The primary decision will be whether the corporation should purchase all of the assets needed for its operations or whether the professional should retain some funds in order to purchase assets which will then be leased to the corporation. A major problem arises, however, when a going concern is incorporated because determining which assets should be transferred to the corporation and which existing liabilities should be assumed by the corporation can be complex.[17]

Ordinarily, if a taxpayer exchanges property for shares of stock, he will realize a gain or loss on the transaction to the extent of the difference between the adjusted basis of the property transferred and the fair market value of the stock or securities received.[18] Section 351 of the Internal Revenue Code, however, provides a method which, if carefully followed, allows the professional to avoid taxation at the time the business is incorporated.[19] Under section 351, no gain or loss is recognized if "property," including money,[20] is transferred to a corporation by one or more persons "solely in exchange for stock or securities of the corporation," and immediately thereafter such person or persons are "in control" of the corporation.[21] While the terms "property," "solely for," and "stock" seem to have their usual meaning, much litigation has occurred over the definition of the word "securities."[22]

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corporation's lower tax rates to accumulate income until needed or until the professional is in a lower bracket himself. Further, they lose the pension and profit sharing benefit allowed corporations. I.R.C. §§ 1379(a) & (d). Since the problems solved by a subchapter S election can be reduced or avoided by other means, the accounting complexities and other disadvantages of this election far outweigh the advantages for the typical professional forming a corporation.

17. *See generally* Goodman, *Special Section 351 Problems Caused By the Incorporation of Partnerships and Revenue Ruling 70-239*, 1 J. CORP. TAX. 134-35 (1974).

18. I.R.C. § 1001(a).

19. *Id.* § 351(a).

20. Halliburton v. Commissioner, 78 F.2d 265, 268 (9th Cir. 1935); Rev. Rul. 69-357, 1969-1 C.B. 101.

21. I.R.C. § 351(a). It should be noted that section 351 serves to postpone rather than to eliminate the gain or loss. Special rules apply to determine the basis of the property to the corporation and the stock to the incorporator. The basis of the stock or securities received is the basis of the property transferred, less liabilities received by the corporation, less the value of any "boot" received, plus any gain recognized to the transferor on the exchange. *See id.* § 358. The corporation's basis in the property it receives is the transferor's basis, plus the amount of any gain recognized by the transferor. *Id.* § 362(a).

22. *See, e.g.*, Coates Trust v. Commissioner, 480 F.2d 468, 472 (9th Cir. 1973)(install-

Problems arise when shareholders of a closely held corporation intend to finance the initial needs of the business through loans as well as contributions of money and property for capital stock. The advantage of a loan to the corporation is that debt obligations can be repaid from corporate earnings without creating taxable income to the lender.[23] Additionally, interest payments, unlike dividends, are deductible to the corporation[24] although they are income to the recipient. If the professional makes a loan at the time of incorporation, the IRS may take the position that the transfer of money for stock and a note was not in exchange solely for stock or securities and is taxable.[25] To avoid taxation in such a case, the shareholder must establish that the note is a "security." A note or other debt obligation having a term of ten years will usually qualify as a "security" while one having a term below five years will probably not qualify since it does not give the holder a continuing financial interest in the success of the corporation.[26] Debt with excessively long or vague repayment terms should not be used since their terms suggest that repayment of the note is indefinite, unlikely, or not a true fixed obligation in the minds of the parties. Such notes might

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ment sales contract not securities); United States v. Mills, 399 F.2d 944, 948 (5th Cir. 1968)(one-year promissory note is securities); Harrison v. Commissioner, 235 F.2d 587, 590 (8th Cir.)(demand drawing accounts not securities), *cert. denied,* 352 U.S. 952 (1956).

23. Rosenberg v. United States, 21 AFTR 2d 788, 789-90 (C.D. Cal. 1968).

24. I.R.C. § 163(a).

25. *See* Rev. Proc. 72-9 § 4(7), 1972-1 C.B. 720. If a transfer qualifies under section 351 as tax-free except that in addition to stock or securities, the shareholder receives other property or money, the transaction is not rendered totally taxable. Any gain realized by the exchange is recognized only to the extent of the "boot" — the amount of money plus the fair market value of the other property contributed for stock. I.R.C. § 351(b). In a situation where "boot" exists, the amount of taxable gain is not determined by aggregating the bases of the assets transferred and subtracting this total from the fair market value of the stock and "boot" received. Instead, each asset is separately transferred in exchange for a pro rata portion of the consideration received. Rev. Rul. 68-55, 1968-1 C.B. 140. If there would be gain on one or two assets, this gain is realized even if there would be no net gain on the total transaction. This result occurs because if section 351 applies, no loss is recognized even if "boot" is received. I.R.C. § 351(b)(2). If the "boot" is in the form of a debt obligation which does not qualify as a security, the gain recognized may not be reported under the installment sales method. The fair market value of the obligation must be reported in a lump sum in the year of the transfer regardless when it is actually received from the corporation. *See* Dennis v. Commissioner, 473 F.2d 274, 285 (5th Cir. 1973).

26. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 3.40, at 3-25 (3d ed. 1971). *Compare* Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932)(14 month note payable not security) *and* Adams v. Commissioner, 58 T.C. 41, 56 (1972)(2 year note not security) *with* Commissioner v. Neustadt's Trust, 131 F.2d 528, 529 (2d Cir. 1942)(twenty year debentures are securities) *and* George A. Nye, 50 T.C. 203, 213 (1968)(10 year note is security).

be construed by the IRS as an equity security, *i.e.*, stock, instead of a debt obligation.[27] If the note is considered to be stock, the entire repayment of the note, principal, and interest would probably be deemed a dividend potentially taxable at the highest applicable tax bracket to the professionals who advanced the funds to the corporation.[28]

Another requirement for tax-free incorporation is that shareholders transferring assets to the corporation must have control "immediately after" the transfer.[29] For purposes of section 351, " 'control' means the ownership of stock possessing at least 80 percent 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."[30] The incorporation may qualify under section 351 even if there are two or more transferors, provided they are regarded as a group for control purposes. Pursuant to the Treasury regulations, the transfers will be deemed made by a group for this requirement if, prior to the transfer, there is an agreement establishing each transferor's rights, and the transfer of assets is made in an orderly and expeditious manner.[31] Occasionally, the courts have been even more lenient and have required only a general plan among the transferors, not necessarily a legally binding agreement.[32]

In the case of professional corporations, there normally will be no reason for a stock issuance disproportionate to the property transferred unless one shareholder will contribute most of the assets and another will receive stock because of the high value placed upon his services. As long as the professional who receives stock for services contributes a reasonable amount of property, he will be included in the transfer group for the purpose of determining control, and the tax-free incorporation should not fail.[33] It should be noted, however,

27. *See* Gilbert v. Commissioner, 248 F.2d 399, 403 (2d Cir. 1957); Erard A. Matthiessen, 16 T.C. 781, 785-86 (1951), *aff'd*, 194 F.2d 659 (2d Cir. 1952); Joseph H. Hubbard, 21 T.C.M. (P-H) ¶ 52,287, at 859 (1952); I.R.C. § 385.

28. *See* I.R.C. §§ 301(c), 302(d).

29. *Id.* § 351(a).

30. *Id.* § 368(c).

31. Treas. Reg. § 1.351-1(a)(1)(1967).

32. *See* Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940). *See also* Von's Inv. Co. v. Commissioner, 111 F.2d 440, 442 (9th Cir. 1940); Baker Commodities, Inc., 48 T.C. 374, 401 (1967); Royal Marcher, 32 B.T.A. 76, 77-78 (1935).

33. *See* Treas. Reg. § 1.351-1(a)(1) (1967); S. Rep. No. 1622, 83d Cong., 2d Sess. 264, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4785, 4901. A disproportionate transaction,

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that under the Texas Business Corporation Act, stock may not be issued in consideration of future services.[34] If a professional is to receive stock for contributing services instead of property, he must actually perform those services before the stock may be issued.[35]

Assumption of Liability Problems under Section 357

A major pitfall in attempting a section 351 tax-free incorporation is found in section 357. While section 357(a) in general provides that the tax-free result of a section 351 incorporation is not affected by the assumption of the transferor's liabilities by the corporation, the Code has two exceptions.[36] First, if the assumption of the liabilities by the corporation is for the principal purpose of avoiding tax or was without a bona fide business purpose, it will be treated by the transferor as receipt of money.[37] This section prevents a taxpayer from borrowing money immediately before incorporation, with the intention of retaining the cash and having the corporation assume the liability or take property subject to it.[38] Secondly, if the total liabilities assumed by the corporation exceed the adjusted basis of the property transferred, the excess is considered gain to the stockholders on the exchange.[39] Most professionals use cash basis accounting in which accounts receivable and work in progress have a zero basis.[40] Frequently, these accounts receivable and the work in progress are the largest assets of the practice, and without them, the accounts payable exceed the depreciated basis of the other property. Thus, section 357 presents the major problem to incorporating an established practice where the professional desires to transfer all receivables and all payables to the corporation. If the IRS is correct in its interpretation of section 357(c), the total liabilities of such a

however, may be treated by the IRS in such a manner to reflect the true reason for the non-pro rata stock issue. Treas. Reg. § 1.351-1(b)(1) (1967).

34. *See* TEX. BUS. CORP. ACT ANN. art. 2.16(A) (Vernon Supp. 1978).

35. *See id.*

36. *See* I.R.C. § 357(b), (c).

37. *Id.* § 357(b)(1).

38. *See* F.W. Drybrough, 42 T.C. 1029, 1047 (1964) (mortgage on property), *aff'd in part, rev'd in part,* 376 F.2d 350 (6th Cir. 1967); W.H. Weaver, 32 T.C. 411, 432 (1959) (loan), *aff'd sub nom,* Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960).

39. I.R.C. § 357(c)(1)(B).

40. *See* P. A. Birren & Son, Inc. v. Commissioner, 116 F.2d 718, 719 (7th Cir. 1940); Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1177 (M.D. Pa. 1973), *aff'd,* 490 F.2d 1172 (3d Cir. 1974); Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 533 F.2d 1114 (9th Cir. 1976); Rev. Rul. 69-442, 1969-2 C.B. 53.

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professional practice would exceed the basis of its assets, and incorporation of an established practice in this manner would be considered a taxable exchange which would discourage incorporation.[41]

Taxpayers have urged that considering accounts payable as liabilities and accounts receivable as zero basis assets for section 357(c) purposes produces a harsh result and contravenes congressional intent to allow businesses to incorporate tax free under section 351.[42] Whether the IRS is correct in its interpretation of section 357(c) has been a source of considerable litigation in the Tax Court[43] which, until recently, had consistently held that section 357(c) was not governed by the nature of the liabilities assumed or the philosophy behind section 351.[44] Under the Tax Court reasoning, tax liability would arise if there was an excess of liabilities, including payables, over the basis.[45] The Second and Ninth Circuits have reversed the Tax Court,[46] and the Tax Court has now reevaluated and changed its position.[47] The IRS, however, has not yet indicated it will change its interpretation, probably because the courts' rationale in each of the three cases has differed.[48] Thus this area of the law must be

41. *See* Rev. Rul. 69-442, 1969-2 C.B. 53.

42. *See* Bongiovanni v. Commissioner, 470 F.2d 921, 924-25 (2d Cir. 1972); Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 533 F.2d 1114 (9th Cir. 1976); Peter Raich, 46 T.C. 604, 610 (1966); H.R. REP. No. 1337, 83d Cong., 2d Sess. 1, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4267-68. *See generally* Comment, *Section 357(c) and the Cash Basis Taxpayer,* 115 U. PA. L. REV. 1154, 1163-69 (1967).

43. *See, e.g.,* Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 553 F.2d 1114 (9th Cir. 1976); Peter Raich, 46 T.C. 604, 610 (1966); John P. Bongiovanni, 40 T.C.M. (P-H) ¶ 71,262, at 1184 (1971), *rev'd,* 470 F.2d 921 (2d Cir. 1972).

44. *See, e.g.,* Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 553 F.2d 1114 (9th Cir. 1976); Peter Raich, 46 T.C. 604, 610 (1966); John P. Bongiovanni, 40 T.C.M. (P-H) ¶ 71,262, at 1184 (1971), *rev'd,* 470 F.2d 921 (2d Cir. 1972).

45. *See, e.g.,* Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 533 F.2d 1114 (9th Cir. 1976); Alderman v. Commissioner, 55 T.C. 662, 664-65 (1971); John P. Bongiovanni, 40 T.C.M. (P-H) ¶ 71,262, at 1184 (1971), *rev'd,* 470 F.2d 921 (2d Cir. 1972).

46. Thatcher v. Commissioner, 533 F.2d 1114, 1118 (9th Cir. 1976); Bongiovanni v. Commissioner, 470 F.2d 921, 925 (2d Cir. 1972).

47. Focht v. Commissioner, 68 T.C. 223, 229 (1977).

48. In *Bongiovanni* the court held that accounts payable, while liabilities for accounting purposes, were not liabilities for tax purposes under I.R.C. § 357(c) until paid. Bongiovanni v. Commissioner, 470 F.2d 921, 924 (2d Cir. 1972). In *Thatcher,* the Ninth Circuit took the position that accounts payable were liabilities for I.R.C. § 357(c) purposes, but it gave the taxpayer a set-off of trade accounts receivable transferred against trade accounts payable transferred, up to the lesser of the trade accounts payable or the gain recognized under I.R.C. § 357(c). Thatcher v. Commissioner, 533 F.2d 1114, 1117-18 (9th Cir. 1976). The Tax Court in *Focht* held that accounts payable could not be treated as a liability under I.R.C. § 357 to the extent their payment would have been deductible if paid by the transferor. Focht v. Commissioner, 68 T.C. 223, 229 (1977).

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regarded as unsettled, and in order to avoid assumption of liabilities in excess of the adjusted basis of assets, accounts payable should not be blindly assumed by the corporation. Instead, a sufficient amount of receivables should be retained to allow the professional to collect enough cash to retain and pay the accounts payable.[49] While avoiding the section 357 problem, this strategy has the disadvantage of continuing the sole proprietorship or partnership, in conjunction with the corporation solely for the purpose of collection of the accounts receivable and payment of the liabilities. This continuation will require the nuisance and expense of maintaining two sets of books during this temporary period, but the extra expenses can be reduced somewhat by having the corporation, for a small fee, act as a collection and paying agent. Payment to the corporation for this collection and payment services should avoid any question about the true and separate nature and existence of the new corporation.

There are other problems to be considered in determining whether accounts receivable and accounts payable should be transferred to the corporation. For example, the IRS might contend that transferred accounts receivable are taxable to the transferor professional, not the corporation, under the "assignment of income" doctrine.[50] Recent cases, however, tend to reject this treatment as inconsistent with the aims of section 351,[51] and generally the IRS will allow the corporation to report the receivables when paid. Nevertheless, if income is substantially distorted, such as deliberately avoiding or delaying the collection of receivables until after the incorporation, the assignment of income doctrine remains a potential hazard.

The decision whether or not to transfer the accounts payable can present a more difficult problem than the determination concerning

49. The IRS will frequently object to the complete splitting of receivables from payables even if the professional does not need the cash from the receivables to meet the payables. *See* XVIII AMERICAN BAR ASSOCIATION, BULLETIN OF THE SECTION OF TAXATION 115-16 (1965); Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX. 88, 91 (1970).

50. Income received for personal services is generally taxable to the person who earns it even though he assigns it to another. Helvering v. Eubank, 311 U.S. 122, 124 (1940); Lucas v. Earl, 281 U.S. 111, 114 (1930); *see* Brown v. Commissioner, 115 F.2d 337, 339 (2d Cir. 1940). Under the "assignment of income" doctrine, taxation on certain income may not be avoided by an individual or a partnership through a contract which provides for the diversion of such income to some other person or entity. *See* United States v. Basye, 410 U.S. 441, 447-48 (1973).

51. *See, e.g.*, Hempt Bros., Inc. v. Commissioner, 490 F.2d 1172, 1177 (3d Cir. 1974); Arthur L. Kniffen, 39 T.C. 553, 561-62 (1962); Thomas W. Briggs, 25 T.C.M. (P-H) ¶ 56,086, at 56-358 (1956)(rejecting cases applying this doctrine as inapplicable).

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accounts receivable because of the unsettled question whether or not expenses incurred by the professional can be deducted by a corporation which did not even exist at the time the liabilities were incurred.[52] Nevertheless, where *all* of the accounts receivable and *all* of the accounts payable are transferred to the corporation, the IRS has taken the position that the corporation may take a tax deduction for the payables it discharges, provided the payables would have been deductible if paid by the transferor.[53] Where the minimum payables necessary to avoid a section 357(c) problem and an equal amount of accounts receivable are retained by the transferor, the IRS permits an exception to its requirement that all receivables and payables be transferred.[54] While the IRS could be requested to give a ruling, realistically there is usually not enough time to obtain the ruling and closing agreement required in these situations when the corporation is being formed.[55] Therefore, if accounts payable are to be assumed by the corporation, it is best to minimize them by paying as many bills as possible before the assignment to the corporation, and then transferring the remainder of the liabilities along with accounts receivable.[56]

Leasing in Lieu of Transfers

The professional and his advisors also should give some thought about what other assets should be transferred to the corporation. It is not necessarily wise to transfer all of the assets used by the professional to the corporation. Frequently, it is better for the professional to keep real estate and major items of equipment and lease them to the corporation. This strategy allows the professional to retain the tax benefits flowing from ownership of the assets. Leasing such items also avoids the problem of over-valued stock by keeping the

52. *See* Focht v. Commissioner, 68 T.C. 223, 229 (1977); [1978] 17 BUSINESS ORGANIZATIONS (Bender) § 12.06, at 12-37 to 38. *Compare* W.D. Haden Co. v. Commissioner, 165 F.2d 588, 590-91 (5th Cir. 1948)(loss not deductible) *with* Peter Raich, 46 T.C. 604, 606-07 (1966)(government indicated agreement with deductibility by the transferor) *and* Bongiovanni v. Commissioner, 470 F.2d 924, 925 (2d Cir. 1972)(loss deductible).

53. *See* XVIII AMERICAN BAR ASSOCIATION, BULLETIN OF THE SECTION OF TAXATION 114 (1965); Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations,* 32 J. TAX. 88, 91 (1970).

54. Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations,* 32 J. TAX. 88, 91 n.11 (1970).

55. *See generally* Rev. Proc. 73-10; 1973-1 C.B. 760; Rev. Proc. 70-17, 1970-2 C.B. 490 (providing checklists for requesting rulings regarding section 351 transfers).

56. The corporation would be relying on receiving treatment consistent with the manner the IRS has handled those who have obtained rulings.

capitalization of the corporation low.[57] Moreover, transferring certain assets could create adverse tax consequences. If the professional has been using accelerated depreciation for certain assets, the transfer of these assets would shift the depreciation method to straight line because the assets would become "used property" upon the transfer.[58] The transfer of depreciated property further creates the problem that if any gain is recognized on a transfer, depreciation will be recaptured to the extent of the gain and taxed as ordinary income.[59] This problem can be avoided by not transferring the depreciated property so that none of the gain is allocated to it.[60] On the other hand, failure to transfer substantially all of the assets, including receivables, necessary to operate a going business will result in recapture of investment credit.[61]

To remedy these problems certain fixed assets can be leased to the corporation. In many cases the depreciation deduction,[62] investment credit,[63] and other deductions[64] produce a substantial tax shelter which can be far more useful to the professional than to the corporation even though the deductions are obtained at the cost of rental income from the corporation. Further, making lease payments to the owners is one way to flow funds from the corporation in a manner that is tax deductible to the corporation.[65] This strategy allows distribution of corporate earnings to shareholders without declaring dividends and thereby avoids the problem of double taxation.

Three problems should be considered in such lease arrangements. First, the rent must be a bona fide amount. If it is too high the IRS

57. Highly valued stock will increase the purchase price of the shares of a deceased or retiring professional and make it difficult for a new associate to purchase stock when joining the firm. Additionally, some professional organizations bring in new members by giving stock to the new associate. Stock so given could constitute compensation, and a high value could create an income tax problem for the new member.

58. *See* I.R.C. § 167(j)(4); Rev. Rul. 56-256, 1956-1 C.B. 129.

59. I.R.C. §§ 1245(a)(gain from disposition of certain depreciable property), 1250(a)(1)(gain from disposition of depreciable realty).

60. For further rules regarding allocation of gain to transferred property, see Treas. Reg. § 1.1245-4(c)(1) (1970); Rev. Rul. 68-55, 1968-1 C.B. 140.

61. *See* I.R.C. § 47; Rev. Rul. 76-514, 1976-2 C.B. 11.

62. I.R.C. § 167(a).

63. *See id.* §§ 38(a)(allowance for investment credit), 46 (rules for computation of credit), 48 (definitions and special rules for investment credit property).

64. *See id.* §§ 162 (repairs, maintenance, and insurance), 163 (interest on purchase loans).

65. *Id.* § 162(a)(3).

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will not allow the deduction to the corporation.[66] Second, if the corporation does not own most of the assets necessary to its operation, especially those not commonly obtained by lease, the true, separate existence of the corporation may be challenged by the IRS. Third, in several situations the lessor professional will not be able to claim the investment credit for property used in his business for less than two years, and he will have to recapture any previously claimed credit.[67] For a lessor to claim the credit, the term of the lease must be less than half the useful life of the property, and the lessor's business deductions for the property, excluding interest, rent, depreciation, and reimbursed items, must exceed fifteen percent of the rental income for the first twelve months of the lease.[68]

Management and Control

The power to manage the business and affairs of professional corporations is vested in a board of directors[69] composed of one or more persons licensed to render the professional service of the corporation.[70] In a typical small professional corporation, each of the shareholder professionals will undoubtedly want a substantial voice in the management of the corporation. To assure this voice, each shareholder professional should be a director. Where ownership is equally distributed, cumulative voting for directors[71] combined with a provision in the by-laws or articles of incorporation setting the number of directors equal to the number of shareholders will accomplish this objective.[72] Other ways to assure a shareholder a board

66. *See, e.g.*, Wade Motor Co., 26 T.C. 237, 244 (1956), *aff'd*, 241 F.2d 712 (6th Cir. 1957); Limericks, Inc., 7 T.C. 1129, 1135 (1946), *aff'd*, 165 F.2d 483 (5th Cir. 1948); Charlie's Cafe Exceptionale, Inc., 16 T.C.M. (P-H) ¶ 47, 004, at 24 (1947).

67. *See* Treas. Reg. § 1.46-4(d)(1)(1972).

68. I.R.C. § 46(e)(3)(B); Treas. Reg. § 1.46-4(d)(1)(1972).

69. TEX. REV. CIV. STAT. ANN. art. 1528e, § 9 & art. 1528f, § 9(A) (Vernon Supp. 1978). Alternatively, an executive committee may be used in the case of a professional association. *Id.* art. 1528f, § 9(A).

70. *Id.* art. 1528e, § 9 & art. 1528f, §§ 9(B), 9(C).

71. With cumulative voting for directors, a shareholder has votes equal to the number of his shares multiplied by the number of directors to be elected. He can cast all his votes for one man or divide them among two or more of the candidates. TEX. BUS. CORP. ACT ANN. art. 2.29(D) (Vernon Supp. 1978).

72. *Id.* For example, if a shareholder has 1/3 of 900 total shares and 3 directors are to be elected, he can cast 900 total votes (300 shares held by him times 3 directors). If he casts all 900 for one person and no votes for the other 2 positions, he is assured his man will be elected. The other shareholders together have 600 shares and 1800 votes. They cannot possibly cast 900 votes for 3 persons, and therefore, cannot defeat the first shareholder's candidate.

position are by a provision in the articles of incorporation or association providing that all shareholders shall be directors or by a side agreement between all the shareholders.[73]

While in the beginning professionals almost always believe that total agreement among themselves is very likely; differences occur, and professionals in a small corporation are unlikely to be satisfied with simple majority rule. Articles of incorporation or bylaw provisions should be adopted requiring at least a two-thirds quorum of the directors or shareholders and a two-thirds vote before any action can be taken. Permitting any shareholder or director a veto is rarely good practice. A deadlocked board of directors or shareholders meeting, unable to take action, can create as much difficulty and lasting resentment as a majority who causes what a minority professional perceives to be "his corporation" to proceed against his will. Thus, employment contracts and share-purchase agreements should be drawn which allow dissatisfied professionals to withdraw from the corporation without delay or unreasonable difficulty and with fair compensation for their interests. When all shareholders know that an important professional can easily withdraw, they usually take extra care to try to work out their differences. But when major differences cannot be resolved, continued professional practice together is usually impractical.

Fiscal Year Planning

A new corporation may select its own fiscal year for tax purposes.[74] This option offers two mild tax planning variations. First, if the professional corporation will not distribute all of its income, it might consider a short tax year for its first return in order to keep the corporation in a lower tax bracket, even if substantial taxable income is anticipated during the first twelve months of operation.[75] A second variation for a corporation on the cash basis method of ac-

73. For a discussion of those control methods, see 1 F. O'NEAL, CLOSE CORPORATIONS § 3.14 (2d ed. 1977). Using the close corporation provisions to eliminate the board of directors and provide for direct management by the shareholders is not prudent since it eliminates centralized management, a characteristic of corporations, and if combined with other problems, may lead to IRS attack on the validity of the corporation. *See* Treas. Reg. § 301.7701-2(c) (1977). *See also* TEX. BUS. CORP. ACT ANN. art. 2.30-1(G) (Vernon Supp. 1978).

74. I.R.C. § 441(f)(1) (granting right of election); *see* Treas. Reg. § 1.441-1(e) (1972) (defining fiscal year).

75. The temporary raising of the threshold for the 48% rate to $50,000 eliminates these considerations as a practical matter for almost all professional corporations.

counting is to select January 31 as the year end. If the corporation declares a legitimate bonus to professional employees in January, the corporation receives a deduction for the year just ending, but the employee reports the income for his taxable year which is just beginning. The tax on this bonus would not be due until April 15 of the following year, resulting in a potential deferral of fourteen months.[76] In practice, however, the busy period of the corporation's accountant or natural slack seasons in the professional practice are likely to control the selection of the taxable year unless the choice is closely supervised.

The beginning of the taxable year can also be controlled by timing the date of incorporation. Advancing or deferring the date can control whether the corporation or the predecessor practice will report forthcoming income or expenses. Inartful date selection, however, can cause problems of anticipatory assignment of income or the disallowance by the IRS of deductions as not related to expenses of the corporation.[77]

Most professional partnerships and individuals report on a calendar tax year. In unusual situations where the partners individually report on a calendar year and the partnership reports on a fiscal year, a major tax problem can result upon incorporation. The partners will report their respective shares of the income of the partnership in the calendar year in which the last day of the partnership's fiscal year occurs.[78] If they later incorporate and begin to draw monthly salaries from the corporation, the salaries until the end of the calendar year as well as their share of the previously earned partnership income occurring in that year will all be reportable in the same calendar year. This situation could bunch as much as twenty-three months of earnings in the same tax year if the partnership fiscal year ended January 31. There is no way to totally avoid this income bunching problem; however, if the professionals can afford to do without the money, salaries from the corporation can be deferred until after the end of the individual's tax year.[79] Another

76. Of course, the benefit of the deferral will be minimized to the extent the bonus is subject to withholding taxes, or the professional is subject to quarterly estimated payments. *See* I.R.C. § 6015(a)(estimated tax); Treas. Reg. § 31.3402(g)-1 (1965) (withholding for employee bonus).

77. Both problems are discussed above in connection with transfer of assets and liabilities. See notes 18-55 *supra* and accompanying text.

78. *See* I.R.C. §§ 706(a), (c).

79. If the corporation is on the accrual basis for tax accounting, accrued but deferred salaries are deductible to the corporation in the first year if paid within 2-½ months of its end. I.R.C. § 267(a)(2)(A).

way to alleviate the problem is to keep the partnership in existence for collection and distribution of its accounts receivable in order to have this reduced partnership income reported the following year. These two deferral methods would only delay the bunching problem until the next tax year, but the maximum tax on earned income may minimize its impact.[80] The tax import of the bunching problem should be anticipated in the previous year so that the partners can set aside part of their draws to pay the increased tax.

Section 1244 Plans

There is usually little or no danger that the professional practice will fail so that the corporate stock becomes worthless or must be sold at a loss. Nevertheless, the professional corporation should always issue its stock under a section 1244 plan.[81] If there is a loss on the disposition of the stock, original holders of such stock can take an ordinary, rather than a capital loss.[82] All professional corporations should be able to qualify[83] for this plan with stock issued for money or property rather than for stock or securities.[84] Coverage is not automatic, however, since a written plan meeting specific requirements of the Code must actually be adopted.[85] Since the corporation can obtain no advantage by omitting such a plan, even a corporation engaging in a safe, established professional practice should use this planning tool. In fact, many attorneys consider it malpractice to fail to advise clients to adopt such a plan.

BENEFITS

Pension and Profit Sharing Plans

The most important single factor in deciding whether to incorporate a professional practice is the many benefits that can be obtained from a qualified pension or profit sharing plan. The distinctions between plans which can be adopted by professional corporations and those available to other forms of professional practice are

80. *See id.* § 1348.
81. *See id.* § 1244 (losses on small business stock).
82. *See id.* § 1244a.
83. *See id.* § 1244(c)(2) (requirements of qualification).
84. *See id.* § 1244(c)(1)(D).
85. *See, e.g.*, Ricky v. Commissioner, 502 F.2d 748, 751 (9th Cir. 1974); Anderson v. United States, 436 F.2d 356, 359 (10th Cir. 1971); Spillers v. Commissioner, 407 F.2d 530, 533 (5th Cir. 1969); I.R.C. § 1244(c)(1)(D).

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significant[86] although the practical considerations of establishing a qualified retirement plan are complex and beyond the scope of this article.

Currently, there is one retirement plan of special interest concerning professional corporations. It involves a group of professional corporations which form a partnership that then performs the professional services. Under such a plan, the partnership contracts with a non-professional corporation owned by the professionals which hires non-professionals and other non-owners to supply support services to the professional corporations. The professional corporations adopt retirement plans, but the non-professional corporation does not provide retirement plans for its employees commensurate with those covering the shareholder professionals in the professional corporations. In these cases, the IRS takes the position that the employees of the non-professional corporation were actually controlled by and attributable to the professional corporations, and therefore, has maintained that the professional corporations' plan was not qualified because it did not meet the employee eligibility requirements.[87] Litigation on this problem has produced mixed results.[88] It appears that where no one individual or professional corporation has control of the non-professional corporation, the non-professional corporation employees are not in fact under the direction and supervision of the professional corporations, and there are no shared employees who work 1000 hours a year for a professional corporation, then the employees of the non-professional corporation may be excluded from the retirement plans of the professional corporations to whom services are rendered.[89] At the present time, however, there are no clear guidelines, and those attempting such an arrangement must proceed cautiously.

86. Plans covering sole proprietors and most partners have the following restrictions: (1) deductible contributions are limited to the lesser of $7,500 or fifteen percent of earned income; *see* I.R.C. §§ 401(d)(5), 404(e); (2) they cannot practically be integrated with social security; *see* § 401(d)(6); Treas. Reg. § 1.401-12(h)(1) (1976); (3) there is a penalty on distributions before age 59-½; I.R.C. § 401(d)(4)(B); and (4) there can be no deferred vesting or forfeitures; *see* I.R.C. § 401(d)(1)(A); Treas. Reg. § 1-401-12(g) (1976).

87. *E.g.*, Kiddie v. Commissioner, 69 T.C. ___, ___, 69 T.C. (P-H) ¶ 69.94, at 588-69 (1978); Burnetta v. Commissioner, 68 T.C. 387, 402 (1977); Packard v. Commissioner, 63 T.C. 621, 637 (1975); *see* I.R.C. § 410.

88. *Compare* Kiddie v. Commissioner, 69 T.C. ___, ___, 69 T.C. (P-H) ¶ 69.94, at 588-69 (1978) (plan disqualified) *with* Burnetta v. Commissioner, 68 T.C. 387, 402 (1977)(plan approved) *and* Packard v. Commissioner, 63 T.C. 621, 637 (1975)(plan approved).

89. *See* Burnetta v. Commissioner, 68 T.C. 387, 402 (1977); Packard v. Commissioner, 63 T.C. 621, 637 (1975).

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Group Term Life Insurance

Another major benefit for professional corporations is life insurance. Premiums are deductible by the corporation[90] and are not taxable income to the employee to the extent of $50,000[91] of group term life insurance coverage on each employee.[92] Additionally, an employee may assign the incidents of ownership of his policy and totally remove the insurance proceeds from his estate for federal estate tax purposes.[93] In practice, the professional often becomes so preoccupied with the details necessary to form and organize the corporation that he overlooks the ability to avoid estate taxes on life insurance proceeds.

Not every group, however, is eligible for these benefits. If less than ten full time employees are covered the group insurance premium will not be excluded from the insured's income unless (1) all full time insurable employees are covered and the coverage is based either on a uniform percentage of salary or coverage brackets and (2) evidence of uninsurability is determined solely on the basis of a medical questionnaire and not a medical examination.[94] Additionally, in Texas a master policy for group life cannot be written for a group containing less than ten members.[95] A corporation with less

90. *See* I.R.C. § 162(a); Rev. Rul. 56-400, 1956-2 C.B. 116.

91. *See* Maurice A. Enright, 56 T.C. 1261, 1263 (1971); I.R.C. § 79(a). If the cost is in excess of $50,000, the excess cost of this insurance is taxable income to the employee, but the cost is determined by the table contained in I.R.C. § 79(c) and Treas. Reg. § 1.79-3(d)(2) (1971). This tax cost is usually less than the actual premium, so even insurance over $50,000 can be desirable.

92. I.R.C. § 79(a). Term insurance contracts often provide other coverage such as double indemnity, travel insurance, or accident and health benefits. Premiums for these coverages are not excluded from the income of an employee when paid by the employer. Treas. Reg. § 1.79-1(b)(1)(ii) (1971). If the policy includes any paid up coverage or cash surrender value, it does not qualify for exclusion from income if the employer pays any part of the premium for such coverage. *Id.* A few years ago insurance companies were offering so-called "section 79 insurance" plans. These plans involved a combination of term and permanent insurance. The IRS is in the process of reviewing its requirements on this type of insurance. *See* Proposed Treas. Reg. § 1.79-1, 43 Fed. Reg. 976, 977-78 (1978). Until this revision is completed the IRS will not issue rulings approving such insurance policies. As the old rulings will not apply to new insurance, and most previously written policies will not meet the proposed requirements, extreme care should be exercised if anyone offers such a policy.

93. *See* Rev. Rul. 72-307, 1972-1 C.B. 307; Rev. Rul. 69-54, 1969-1 C.B. 221. Such an assignment must be allowed by the policy and permitted by state law. The Texas Insurance Code allows such assignment. *See* TEX. INS. CODE ANN. art. 3.50, § 2 (Vernon Supp. 1963-1977).

94. Treas. Reg. § 1.79-1(b)(1)(iii)(d) (1971). Further, if coverage brackets are used, no bracket may exceed 2½ times the prior bracket, and the lowest bracket must be at least ten percent of the highest.

95. TEX. INS. CODE ANN. art. 3.50, § 1(c) (Vernon Supp. 1963-1977).

than ten employees to be covered will be unable to take advantage of this fringe benefit by its own group insurance contract. Nevertheless, small groups can sometimes use one of two methods to get group coverage tax treatment in Texas. First, some professional organizations offer term insurance to member professionals and their employees.[96] Because the corporation's group plan does not have to be part of an insurance master policy[97] and that policy may cover persons other than the corporation's employees,[98] a small professional corporation may prepare its own group insurance plan and use policies obtained under the professional organization's master policy.[99]

A second solution is the use of so-called "wholesale," "mass-marketed," or "franchise" insurance plans. Under these and similar arrangements, an insurance company puts together a group of individual term policies for an employer or combines two or more small employers to form a group large enough to issue a master group term policy. These plans can qualify for the exclusion under section 79,[100] but care must be exercised that the insurance company's contract with the professional corporation meets the tax requirements previously discussed.

Health Benefit Plans

The low cost and tax benefits of group hospitalization, surgical and medical, and major medical insurance make such insurance a fringe benefit which should be investigated by most professional corporations. It is also the fringe benefit most frequently expected, and often most appreciated, by the lower income, non-professional employees. Group plans offered by most insurance companies are substantially less expensive than individual policies for the same coverages. Further, many different combinations of programs are offered providing great flexibility with percentage of costs covered, deductibles, and maximum coverage.

The payment of the premiums by the corporation is deductible as an ordinary and necessary business expense.[101] Neither the prem-

96. An example of such a plan is the State Bar of Texas Insurance Trust.

97. *See* Treas. Reg. § 1.79-1(b)(1)(i)(1971).

98. *See id.* § 1.79-1(b)(1)(iii)(a)(1971).

99. *Id.* § 1.79-1(b)(3)(1971).

100. I.R.C. § 79.

101. *See* Treas. Reg. § 1.162-10(a) (1960); Rev. Rul. 58-90, 1958-1 C.B. 88 (disability insurance); Rev. Rul. 56-632, 1956-2 C.B. 101 (accident and health insurance); Rev. Rul. 210, 1953-2 C.B. 114 (accidental death and disability insurance).

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iums paid by the employer[102] nor the benefits received by the employee (directly or indirectly) in payment of medical expenses are taxable to the employee.[103] Further, the health insurance coverage may include the employee's spouse and dependents.[104]

There are two drawbacks, however, to group health insurance programs. First, most insurance master policies require coverage of substantially all the employees. For financial or other reasons, the shareholder/professionals may want to provide coverage for the benefit of only the professionals or long-term employees. Secondly, even if full employee coverage is desired, the professional corporation may have too small a group of employees to qualify for an insurance contract.[105]

A medical reimbursement plan can be a useful remedy to these problems. Under the typical medical reimbursement plan, the corporation agrees to reimburse or directly pay the medical and dental expenses of a certain class of employees, including expenses incurred for their spouses and dependents. Since most plans include or are coordinated with insurance maintained either by the corporation or by the covered employee, it is usual to provide that only reimbursements for non-insured medical expenses are to be made. Additionally, plans should usually have a maximum amount of coverage. A plan containing a maximum coverage provision and limiting coverage to non-insured expenses protects the corporation from the burden of unusually large cash demands caused by catastrophic illness or long term rehabilitation and assures that no one professional or other employee will burden the plan or benefit from it substantially more than others. Corporate payments pursuant to the plan, whether paid directly for such medical or dental expenses or for insurance to provide the actual coverage, are deductible.[106] Also, amounts received from the plan or as insurance proceeds for the payment of covered expenses are not taxable to the employee.[107]

Medical reimbursement plans are especially attractive for two reasons. First, there is no prohibition against discrimination among employees, either in the regulations or the Code.[108] Thus, groups of

102. *See* I.R.C. § 106.

103. *Id.* § 105(b).

104. *Id.* § 105(b); *see id.* § 213(a)(1).

105. *See* J. MAGEE, GENERAL INSURANCE 780-82 (5th ed. 1957).

106. *See* I.R.C. § 162; Treas. Reg. § 1.162-10(a)(1960).

107. Treas. Reg. § 1.105-5 (1964); *see* American Foundry v. Commissioner, 536 F.2d 289, 293 (9th Cir. 1976).

108. *See* I.R.C. § 105; Treas. Reg. § 1.105-5(a)(1964).

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employees can be deliberately excluded by careful definition of the class or classes of covered employees,[109] in order to keep costs down. Second, the plan can be an especially good fringe benefit to professionals in high tax brackets whose medical expenses may not qualify as an itemized deduction because they do not exceed one percent[110] or three percent[111] of their adjusted gross income. Frequently these percentage limitations substantially reduce or eliminate the individual medical expense deduction. These limitations, however, do not apply to corporations,[112] and thus, a remarkable opportunity exists to provide medical/dental services to the selected employees and their families with tax-free dollars instead of purchasing such services with post-tax dollars.

The IRS has frequently attacked the exclusion from employee income of payments by corporations under medical reimbursement plans. The attacks have been based on the position that no plan actually existed and only an isolated payment occurred,[113] or that the plan was not limited to employees.[114] In describing the employee group covered, emphasis should be placed on the existence of the employer-employee relationship. Any reference to the covered individual's status as a shareholder would probably be fatal to the plan.[115] The employee group may be defined as professional employees or officers who perform actual services for the company as employees.[116] It is not actually necessary for the plan to be in writing or contractually enforceable.[117] If the employee's rights are not enforceable, some program, policy, or custom can be deemed to constitute a plan provided the employee has reasonable notice of such

109. *See* Treas. Reg. § 1.105-5(a)(1964).

110. I.R.C. § 213(b)(medical expense deduction).

111. *Id.* (a)(1)(deduction for medicine and drugs).

112. The corporation's deduction is allowed by I.R.C. section 162 and not section 213.

113. *See* Sebastian Bongiovanni, 45 T.C.M. (P-H) ¶ 76,131, at 578 (1976).

114. Alan B. Larkin, 48 T.C. 629, 635 (1967), *aff'd,* 394 F.2d 494 (1st Cir. 1968); John H. Kennedy, Inc., 46 T.C.M. (P-H) ¶ 77,210, at 880-A (1977); Edward D. Smithback, 38 T.C.M. (P-H) ¶ 69,136, at 762 (1969).

115. *See* Sebastian Bongiovanni, 45 T.C.M. (P-H) ¶ 76,131, at 578 (1976). *But see* Arthur R. Seidel, 40 T.C.M. (P-H) ¶ 71,238, at 1076 (1971).

116. *See* American Foundry v. Commissioner, 536 F.2d 289, 294 (9th Cir. 1976); Nathan Epstein, 41 T.C.M. (P-H) ¶ 72,053, at 231 (1972); E.B. Smith, 39 T.C.M. (P-H) ¶ 70,243, at 1167 (1970); Bogene, Inc., 37 T.C.M. (P-H) ¶ 68,147, at 813 (1968). *See also* Charlie Sturgill Motor Co., 42 T.C.M. (P-H) ¶ 73,281, at 1299-300 (1973).

117. Treas. Reg. § 1.105-5(a) (1964); *see* Greer v. Commissioner, 70 T.C. ___, ___, 70 T.C. (P-H) ¶ 70.26, at 70-167 (1978). Nevertheless, a non-tax portion of the Pension Reform Act (ERISA) requires that such plans be in writing. *See* 29 U.S.C. §§ 1002(1), 1102(a) (Supp. V 1975).

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plan.[118] Nevertheless, the only way to be sure that the plan will be recognized by the IRS is to have the board of directors adopt it in writing.

Disability Insurance

Another fringe benefit regularly found in professional corporations is the purchase of disability insurance by the corporation for its professionals. The premium payments are deductible by the corporation[119] and are not considered income to the professional employee.[120] At one time only disability benefits received in excess of $100 per week were includable in gross income,[121] but as of January 1, 1976, the excludable amounts are reduced dollar for dollar by all adjusted gross income in excess of $15,000.[122] Therefore, if a disabled professional earned in excess of $20,200 in adjusted gross income, all disability benefit payments received would be taxable. If the professional personally buys and pays for disability insurance from his own funds because the corporation does not offer it to its employees, he will not receive a deduction, but benefits received under the policy will be entirely tax-free.[123] This alternative might have an advantage over policies provided by the corporation if the professional needs the full benefit, unreduced by taxes. During a disability, however, the professional may be in a lower income bracket and current exclusions of the premium dollars from income in the high earnings period prior to disability might be more important than tax-free benefits to the professional if and when he ever becomes disabled.

Death Benefits

The professional corporation can provide an income tax free death benefit up to $5,000 to an employee's estate or beneficiary[124] which will be tax deductible to the corporation.[125] This benefit may be paid

118. *See* Greer v. Commissioner, 70 T.C. ___, ___, 70 T.C. (P-H) ¶ 70.26, at 70-167 (1978).

119. See regulations and rulings cited note 101 *supra*.

120. I.R.C. § 106.

121. J. Doheny, Mertens Law of Federal Income Taxation Tax Reform Act of 1976 Analysis 25-26 (Supp. 1977)(code commentary).

122. I.R.C. § 105(d).

123. *Id.* § 104(a)(3); Treas. Reg. § 1.104-1(d)(1970).

124. I.R.C. § 101(b).

125. *Id.* § 404(a)(5).

voluntarily by the corporation or pursuant to a contract establishing such benefits. If paid voluntarily, it also will be excluded from the deceased employee's estate for estate tax purposes.[126] If paid pursuant to a contract, it will be included in the employee's estate under section 2033 of the Internal Revenue Code.[127] The professional and his advisor should be cautious about planning for voluntary payments tax-free to his estate because the corporation's surviving directors might not make the payments voluntarily. It should be noted that this excludable death benefit provision also can apply to the first $5,000 received under a death benefit paid by a qualified pension or profit sharing plan.[128] When a deceased shareholder's shares are to be sold to surviving shareholders, it is also possible to reduce the purchase price of the deceased shareholder's stock in a buy-sell agreement by $5,000 and provide this benefit in order to save the capital gains tax on that amount while delivering the same amount of cash.[129] If this action is taken, a corporate resolution, properly recorded in the minutes after the stockholder's death, should document that the payment is a true death benefit and not a payment for stock.

Building Evidence that the Existence of the Corporate Entity Has Been Respected

Since the burden of proof is usually on the taxpayer to rebut the assertion of a tax deficiency by the IRS, it is sound practice to have the evidence available for such a rebuttal. In *Jerome J. Roubik*[130] the IRS was able to disregard the presence of a corporation, although it satisfied state law, and tax the income directly to the professionals because they had entirely ignored the corporation and had not properly handled their post-incorporation operations.[131] This case illustrates the need to operate as a corporation after the articles of incorporation are filed. Frequently, in the time immediately following incorporation, many operating details remain that professionals

126. Rev. Rul. 65-217, 1965-2 C.B. 214.

127. *See* I.R.C. § 2033.

128. *See* Treas. Reg. §§ 1.101-2(b) (1975), 1.72-16(c)(1963).

129. Because a shareholder's basis in his stock after a section 351 exchange is usually less than its value and under the carry-over basis rules now in effect for a decedent's property under section 1023, there will usually be gain on the purchase of a deceased shareholder's stock.

130. 53 T.C. 365 (1969).

131. *Id.* at 381.

overlook. While no cases can be found which turn solely upon the failure of the taxpayer's records to show any one of these details, meticulous attention to them will enhance the ability to prove the existence of the corporate entity apart from the professional. The two actions the authors most often find omitted include the failure to issue stock certificates[132] and the failure to outwardly demonstrate a change of identity reflecting the new corporate form.[133]

To protect his position, the professional should prepare written employment contracts containing not only the usual salary, employment term, vacation, and sick pay features, but also contractual provisions reserving to the corporation the exclusive right to assign performance of professional services for the corporation's patients (clients) to any of its professional employees. Otherwise the income received by the corporation might be considered "amounts received under personal service contracts,"[134] and the corporation would be vulnerable to attack as a personal holding company.[135] The employment contract should also set out the maximum amount of time away from the practice during which compensation will be paid and expenses allowed the professional for continuing education. Such a provision will avoid the development of tension in the situation where one professional attends many continuing education sessions at the corporation's expense while the other professionals remain at home grinding out the work and earning the corporate income.

If the employee professional is required to make out-of-pocket expenditures on behalf of the corporation for which he will be subsequently reimbursed, the employment contract should also contain a clause requiring the professional to repay any amounts reimbursed by the corporation which are subsequently disallowed as tax deductions by the IRS. This provision will avoid having the disallowed amount taxed both to the professional and the corporation.[136] Such an agreement is not a panacea to hedge against payments likely to

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132. Completed transfer ledgers and relevant legends indicating the presence of voting trusts, stock redemption agreements, buy-sell agreements, and other restrictions of rights should be written on the certificates.

133. Items such as letterhead, stationery, calling cards, bank accounts, telephone listings, listings in directories and trade journals, and credit cards need to be changed.

134. *See* I.R.C. § 543(a)(7)(A); Rev. Rul. 75-250, 1975-1 C.B. 172.

135. I.R.C. §§ 541 (imposing 70% tax on undistributed personal holding company income), 542 (defining personal holding company), 543 (defining personal holding company income).

136. *See* Rev. Rul. 69-115, 1969-1 C.B. 50.

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be disallowed, however, since its presence can evidence the unreasonableness of payments.

When the initial papers relating to incorporation are completed, professionals often believe they have done everything necessary to assure their tax benefits and cease to pay attention to the details required for respecting the corporate entity. Until the professional can acquire the habit of acting as a corporation in the area of corporate affairs, frequent board meetings with the tax advisor should be held. The authors find that during the corporation's first year, quarterly meetings effectively reinforce the ideas that the entity should be respected and that no personal expenditure should be camouflaged and deducted as a corporate expense.[137] The professional must be reminded never to draw money or corporate property out of the corporation for personal use, allow the corporation to pay for personal services to the professional, or do anything any employee or colleague could imagine, misinterpret, or perceive to be an infringement upon the corporate entity. IRS scrutiny of the personal use of corporation assets will likely increase and be a fertile area for audit.

To prevent the professionals from forgetting to keep up with the necessities of corporate life, a tickler calendar should be established to notify a responsible party when it is time to have meetings of the board of directors and shareholders. Such meetings should actually be held so that those attending can testify that they attended and corporate business was actually conducted. The practice of "backdating" minutes should be scrupulously avoided since the IRS watches closely for such actions. It would be very damaging if one of the supposed attendees was actually out of town on the date of the purported meeting.

To insure that no significant matter will be omitted, an agenda should be prepared by the tax advisor and delivered in advance of the meeting to the professionals. Written minutes of the business conducted should be kept, reflecting matters such as reviews of the professional practice and specific actions by the board. Successive

137. *See* Sigel G. Roush, D.D.S., Inc., 71 T.C.M. (P-H) ¶ 78, 115 (1978). In *Roush* the Tax Court disallowed a mileage-driven deduction for trips of a personal nature, disallowed the travel and entertainment expenses of a colleague which bore no relation to the corporate business, and held the payments to the professional for the personal entertainment expense and the fair market value of the use of the corporation's automobile for personal trips to be a constructive dividend. Adding insult to injury, the court upheld the IRS's assessment of a negligence penalty. *Id.*

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minutes of meetings should not be similar "form" minutes but should have some substantive differences so that the professionals can demonstrate that they are actually operating and acting within the corporate entity.[138] Special attention should be paid to insure that there are no blanks in the minutes and that they are actually dated and signed.

In order to demonstrate another distinctive corporate trait, the board of directors should consider declaring a dividend at the annual meeting, and their discussion of the dividend should be included in the minutes of the meeting to demonstrate a record of paying dividends. By paying dividends the corporation can minimize its earnings and profits. A dividend of $100 is especially attractive since the first $100 of dividends received will be excludable from the professional's gross income.[139]

Finally, since professionals usually withdraw cash from the corporation frequently and since many professional corporations are capital-intensive, the professionals are often forced to loan the corporation money. Because the professional and his corporation are related parties, any loan which may exceed six months should be evidenced by a written note bearing seven percent interest at the minimum,[140] in order to avoid the unfavorable reallocation of deductions between the corporation and the professional[141] or the repayment of the debt being classified a dividend by the IRS.

DEATH, DISABILITY, AND WITHDRAWAL

Numerous problems arise when the shares of a professional corporation change hands.[142] Such situations arise in cases of death, disability, withdrawal, expulsion, and admission of new professionals. To prevent any difficulties that might develop under such circumstances, a buy-sell agreement[143] between the shareholders is a virtual necessity.

138. While directors in major corporations do not approve all employment contracts, salary arrangements, capital purchases, and borrowings, such behavior would be prudent for the professional corporation. Further, when relatively major steps are involved, these actions should be authorized by the board in advance. Minor actions can be reviewed and ratified annually.

139. *See* I.R.C. § 116; Treas. Reg. § 1.61-9(a)(1962).

140. *See* Treas. Reg. § 1.482-2(a)(2)(1975).

141. I.R.C. § 482.

142. *See* Lee, *Termination of Interest in the Professional Corporation*, in 1 New York University Proceedings of the Thirty-Sixth Institute of Federal Taxation 123, 124 (N. Liakas ed. 1978).

143. The agreement would be either an entity purchase agreement or a cross purchase agreement, whichever is best under the circumstances.

Withdrawal

At the beginning, the future shareholders in a proposed typical professional corporation believe that the organization and his colleagues are and will continue to be ideal. They seldom perceive the need to plan for painless withdrawal in the event the close working relationships cause hidden resentment and discomfort between some members of the organization. By the time hostility surfaces, it is usually too late to coolly negotiate a peaceful withdrawal. When both sides have already agreed in writing upon the method for splitting the corporation under these circumstances, however, everything can proceed in a businesslike fashion. When advised of this problem, the professional often minimizes it but will immediately perceive the situation when asked how to remove a professional shareholder who does not wish to be removed or does not like the proposed terms of removal.

For example, if one of the professional shareholders was accused of professional impropriety in a lawsuit and the remaining shareholders wished to expel him, the accused professional, already sensitized by the mere accusation, would not be likely to discuss his expulsion objectively. Therefore, a buy-sell agreement containing an option for the corporation or its assignees to purchase the shares of the accused professional would avoid confrontation negotiations and permit the corporation to resume its affairs quickly. Such a provision would allow the corporation to expel the accused and require him to offer his shares for sale upon a vote of a predetermined percentage of the other shareholders. If the corporation desired, it could then replace the lost specialty of the accused by selecting a new professional qualified in that specialty to buy the accused's shares.

Disability and Withdrawal

Where one of the professionals becomes disabled and is unable to practice for long periods of time, the corporation's assets are constantly depleted by his salary and the corporation is deprived of both his specialized services and the income he earns.[144] An advance

144. For a further discussion of the effect of disability of a professional in the professional corporation, see Lee, *Termination of Interest in the Professional Corporation*, in 1 NEW YORK UNIVERSITY PROCEEDINGS OF THE THIRTY-SIXTH INSTITUTE ON FEDERAL TAXATION 123, 139-40 (N. Liakas ed. 1978).

agreement giving the corporation, its assignees, or the other shareholders the right to purchase the disabled professional's interest after a specific period of disability will protect the corporation. Typically, however, the spouse of the disabled professional does not wish to deflate the disabled's hope of recovery and resists the purchase of his shares. Thus an agreement containing a durable power of attorney[145] naming the secretary of the corporation and successors to repurchase the shares or designate who will buy the shares from the disabled party under these circumstances is a corporate necessity.

The agreement should also provide that a professional retiring from active practice have a "put."[146] A "put" forces the corporation or its assignees to purchase his shares in order to prevent leaving an asset in his estate which has little marketable value. Under this agreement, the withdrawing party should have the choice of several methods, such as receiving cash or demanding that the buyer pay him in his choice of a three or five year installment sale in order to enable him to spread his long term capital gain.[147] If the withdrawing professional is in a high tax bracket, it might be reasonable to reduce the cash purchase price by ten percent to encourage a delayed payout favorable to the remaining professionals.[148] The notes should not be prepayable, since the obligors of the note could pay the seller prematurely and destroy the seller's tax planning.[149]

The situation is vastly different when a professional withdrawing from the corporation intends to remain active and to set up a new practice. He might need cash immediately to purchase assets necessary to set up his new practice. Under these circumstances, the ten percent reduction in purchase price, encouraging delayed payout, should probably not be available in order to discourage a sale of the

145. TEX. PROB. CODE ANN. § 36(A) (Vernon Supp. 1978)(power of attorney does not terminate on disability of principal).

146. A "put" is an enforceable contract requiring another to purchase shares, usually at a pre-determined price.

147. *See* I.R.C. § 453(b)(1)(B). An example of possible formula language designating the rate of interest payable is: x percentage points over the prime lending rate published on the date of sale by the XYZ bank but in no event lower than the imputed interest rate of § 483.

148. The seller could then report the gain on the installment sale method. *See* I.R.C. § 453(b). This strategy would spread the gain over several years and may hold it in lower tax brackets than would be the case if the full gain were reported in one year.

149. The fullest spreading over the full installment period would be lost, and if it were prepaid in the first calendar year, the installment reporting method could not be used. *See* I.R.C. § 453(b)(2).

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shares and encourage splitting up the present corporation into two corporations via a tax-free "split off"[150] with no cash required. This "split off" would probably cause some of the tangible assets in the existing corporation to be transferred to reduce the amount of money needed to establish the new professional corporation.

The agreement should further provide in advance which parties will get the office location, favorable leases, and phone number. A formula for the aging of accounts receivable and a statement describing the distribution of the recovery on bad debts, generated before the split but collected afterwards, should be included. The agreement also must contain a clause for the pre-splitup valuation of assets along with a system for selection of the assets, such as choosing them in rotation.

While it is usually better practice to wait until the time of admission of a new professional to decide whether he will be admitted to the practice via the purchase of treasury shares or shares already owned by the present shareholders, an alternative arrangement for his induction should be provided.[151] This arrangement can be accomplished by requiring each of the older members to surrender and sell some of his shares to the new member upon terms of payment to be decided by a majority of the shareholders. Thus, if a majority of the already admitted professionals wanted to sell corporate treasury shares to avoid a long term capital gain on the sale of their own shares, they could do so, but if there was no agreement among the already admitted shareholders, the presence of an alternative arrangement would still permit introduction of a new professional. This plan has the advantage of presenting a single plan of payment to the prospective shareholder while permitting the majority of the sellers to retain the option to use the installment sale method for the majority's benefit despite any recalcitrant shareholder.

Death

Since in Texas only professionals may hold the shares of a professional corporation,[152] one of the chief reasons for preparing a buy-sell agreement is to require the estate of a deceased shareholder to sell his shares to the corporation or its assigns. Such a provision also gives the professionals an opportunity to fix the value of their shares

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150. *See id.* § 368(a)(1)(D).

151. *See generally* H. HENN, LAW OF CORPORATIONS § 124, at 207-215 (2d ed. 1970).

152. TEX. REV. CIV. STAT. ANN. arts. 1528(e)(3)(b) & 1528(f)(2)(B)(Vernon Supp. 1978).

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for estate tax purposes.[153] While shares in a decedent's estate are usually valued at fair market value,[154] the price set in an agreement will usually control for estate tax purposes provided the price is not grossly inadequate.[155]

While a high redemption price may pass more cash into an estate desperately needing it, the surviving shareholders might find the higher price burdensome, especially since it is common for them to feel that the value of the dead colleague's interest "died with him." On the other hand, it is unlikely that each shareholder will be willing to value his shares at a low figure because of personal feelings regarding "a fair price" for his shares. In an attempt to set the price at a fair level, some agreements value the decedent's shares at a pro rata part of net book value. Since most professional corporations use accelerated depreciation which rapidly reduces the book value of the assets and since work in progress and accounts receivable are not often given a value on the books of a cash basis taxpayer,[156] a purchase price related to the book value of the shares may be far below the level of fairness intended. In an attempt to solve this problem, the purchase price of a decedent's shares could instead be set at the proportional fair market value of the assets of the corporation plus accounts receivable and work in progress as annually updated and agreed upon by all the professionals. The problem with this method, however, is that the professionals, occupied with their day-to-day affairs, seldom update the value of the corporate assets, thus defeating the attempt to set a fair purchase price.

Another method which may be more fair to the estate of the deceased would be to set the price at the greater of (1) proportional net book value as adjusted for accounts receivable and work in progress, (2) proportional net value as set by appraisal, or (3) an amount equal to the income earned on behalf of the corporation by the decedent during the last twelve months reduced by the portion of the corporation's overhead expense for his practice. Thus when a professional corporation owned many freshly depreciated assets and

153. *See* Angela Fiorito, 33 T.C. 440, 444 (1959); Estate of Lionel Weil, 22 T.C. 1267, 1269 (1954); Commissioner v. Bensel, 100 F.2d 639, 639 (3d Cir. 1938); Treas. Reg. § 20.2031-2(h)(1976).

154. *See* Rev. Rul. 59-60, 1959-1 C.B. 237.

155. *See* Commissioner v. Bensel, 100 F.2d 639, 639 (3d Cir. 1938).

156. *See* Hempt Bros., Inc. v. United States, 354 F. Supp. 1172, 1176 (M.D. Pa. 1973), *aff'd*, 490 F.2d 1172 (3d Cir. 1974); Thatcher v. Commissioner, 61 T.C. 28, 37 (1973), *aff'd in part, rev'd in part,* 533 F.2d 1114 (9th Cir. 1976); Rev. Rul. 69-442, 1969-2 C.B. 53.

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failed to appraise annually, the decedent's estate would receive his fair share of the assets or, at a minimum, an amount essentially equivalent to one year's earnings.

A problem that often occurs is delay in the repurchase of the decedent's shares. For example, if a shareholder died testate, his will could prevent the independent executor from qualifying until six months after his death, or the executor could improperly oppose the sale. In each of these cases, a temporary administration or other legal proceeding would be necessary to obtain immediate sale of the shares.[157] While no legal penalty is known to exist for failure to immediately divest the shares from the estate, if a new professional is to replace the decedent and be admitted to the corporation via purchase of the decedent's shares, delays could hamper the ongoing affairs of the corporation. As an incentive to avoid delay, the agreement should require the decedent's estate to pay the attorney's fees and indirect costs expended by the corporation in a temporary administration. A provision for a few thousand dollars of liquidated damages also might cause the professional to prepare his will to effectuate rapid sale of the shares upon death.

Types of Agreements

There are two basic kinds of buy-sell agreements, the cross purchase agreement and the entity purchase agreement. They will be discussed in the context of a purchase on death situation. In the cross purchase agreement, each of the shareholders agrees with the others to purchase shares of any decedent. While the surviving shareholders acquire the advantage of a tax basis equal to the purchase price of the decedent's shares purchased, cross purchase agreements have the disadvantage of being complex to administer during life, even in their simplest form. The usual means of providing the cash necessary to buy a decedent's share in a cross purchase agreement is for the professionals to buy life insurance policies on each other's lives. The disadvantage of this method is that a large number of policies may be required, even in a relatively small pro-

157. If no personal representative capable of selling the shares has yet qualified, no other way exists to consumate a sale, and if the executor approves sale, a suit for specific performance would be in order. Also, the estate must immediately invest its shares. *See* TEX. REV. CIV. STAT. ANN. art. 1528e(14)(Vernon Supp. 1978). There is no requirement for diverting shares by an estate but the Texas statute forbids anyone to hold the shares who is not a professional licensed to render the corporation's service. *Id.*; *see id.* art. 1528f(2)(A).

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fessional corporation. For example, a cross purchase agreement for six shareholders would require thirty insurance policies. If left alone without some administrative device to assure the continuation of the insurance with which to fund the purchases, the plan often becomes frustrated because one or more of the parties stops paying insurance premiums on the lives of the other shareholders. The result is that upon a shareholder's death, the estate of the decedent, which planned for this event, expecting to be bought out, and usually needing the immediate cash, will not get it all because some of the shareholders have no money with which to fulfill their contractual obligations. From the point of view of the surviving shareholders, the disadvantage of a cross purchase agreement is that the insurance policy premiums are paid with after-tax dollars,[158] and in the case of professionals those premiums may be substantial.

The other method of purchasing an interest is the entity purchase agreement where the corporation, with after-tax dollars, purchases life insurance payable to the corporation on the life of each shareholder. Upon the death of the shareholder, the corporation redeems the decedent's shares by paying the estate with the cash paid it by the insurance company. If a share purchase agreement does not successfully set the value of the shares, the entity purchase method will subject the life insurance proceeds, at least partially, to estate tax because those proceeds received by the corporation increase its value, thus adding to the value of the shares in fixing their estate tax value.[159] This event would not occur with a cross purchase agreement since the proceeds are received by the other shareholders, and therefore, do not increase the net worth of the corporation. Additionally, when the deceased shareholder's shares are redeemed by the corporation, there is no increase in basis of the shares of the surviving shareholders as occurs when these survivors purchase under a cross purchase agreement. The result may be increased capital gains to the estates of the survivors when their shares are purchased on their subsequent death, retirement, or withdrawal. Another problem with the entity purchase agreement is that if the shareholders are related to one another, section 318 might apply and convert the long term capital gain on the sale of the shares in decedent's estate into a section 301 taxable dividend.

158. *See* I.R.C. § 264(a)(1).
159. *See* Treas. Reg. § 20.2031-2(f)(2)(1976).

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Between the two alternative buy-sell agreements, the better choice is the cross purchase agreement when the purchase price for the shares is high or when shareholders are related. The shareholders can avoid the administrative problems of keeping multiple policies in effect by entering into a trust which will own and purchase the insurance policies.[160] Under this method, the corporation would pay to the trust, for the benefit of each professional shareholder, additional salary equivalent to the amount needed to pay the premiums, which of course would be taxable to the professionals.[161] Although the salaries of the younger shareholders would be disproportionately higher because they are paying premiums on the lives of older shareholders with relatively higher insurance rates, there would be no increase in disposable cash for the younger shareholders. Since under such a plan the income taxes of the younger professionals will go up for the benefit of the estate plans of the older professionals whose lives are insured, improperly explained cross purchase agreements often become a bone in the throat of the younger shareholders. This problem of income distortions is best handled by a direct explanation before the young professional makes his decision to enter the corporation under such terms.

If the purchase price of the shares of the decedent is likely to be low, as is typical in most professional corporations, or if the shareholders are so young that a shareholder's death does not appear imminent, and if none of the shareholders are related under the provisions of section 318, then an entity agreement appears best because dollars earned to pay the annual premiums would be taxed only at the corporate level, and the tax on the premiums paid by or for each of the shareholders in a cross purchase agreement would be avoided. The corporation also would be spared the trust and multiple insurance policy difficulties of a cross purchase agreement.

MISCELLANEOUS AND GENERAL

One-Man Corporations

The existence of a professional corporation with only one profes-

160. Some commentators suggest that this trust could actually own the shares. *See generally* Macdougall, *Closely-held Corporations: Insurance Planning for Redemptions and Buy-Sell Agreements,* 5 EST. PLAN. 52 (1978). This alternative is not available, however, in professional corporations since only professionals may own shares.

161. To prevent this taxation from becoming a problem, regular payroll taxes should be withheld to demonstrate that it is indeed salary. The IRS, however, may find the additional salary excessive and consider it dividends to the shareholders. *See* Treas. Reg. § 1.162-8(1960).

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sional as its shareholder appears to present no problems apart from taxes. Clearly a Texas professional corporation or association can have only one shareholder,[162] one director,[163] and one officer who serves as both president and secretary.[164] There are problems, however, with recognition of the corporation for tax purposes by the IRS since one-man corporations are particularly vulnerable to attack in the use of the corporate structure for two reasons. First, there is an inherent difficulty in separating the ownership of the corporation from its management, and this separation is the essence of corporate organization. As a practical matter, the individual involved often has trouble remembering to conduct his business as a corporation. He frequently forgets whether he should be acting as a shareholder, director, or officer or whether he should act in his own individual name. Second, because the professional remains liable both for his own negligence and for those under his direct control,[165] the ability to demonstrate the limited liability of corporate form, so important in determining whether a corporation exists for tax purposes, is impaired.[166]

In actuality, the service has tacitly acknowledged the corporate existence of many one-man professional corporations. It has issued letters of approval on pension plans submitted by these corporations, and as these plans contain provisions allowable only to corporations, the IRS must be recognizing their corporate existence. A revenue ruling has been issued holding that in most cases a one-man professional corporation will not be subject to the personal holding company tax.[167] Nevertheless, because of these inherent weaknesses of the one-man professional corporation, unusually strict adherence to the formalities and requirements of corporate and tax law is essential. No matter how strained or artificial they may seem, the authors feel all of the steps of corporate existence and management previously discussed must be carefully completed and all of the required instruments fully prepared and executed.

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162. Massachusetts v. Davis, 140 Tex. 398, 413, 168 S.W.2d 216, 224 (1942); *see* Tex. Rev. Civ. Stat. Ann. art. 1528e, § 5 (Vernon Supp. 1978)(applying Business Corporation Act provisions to one-man corporations).

163. Tex. Bus. Corp. Act. Ann. art. 2.32 (Vernon Supp. 1978). *See also* Tex. Rev. Civ. Stat. Ann. art. 1528e, § 9 (Vernon Supp. 1978)(authority and qualifications of directors).

164. Tex. Rev. Civ. Stat. Ann. art. 1528e, § 10 & 1528f, § 9 (Vernon Supp. 1978).

165. *Id.* art. 1528e, § 16 & 1528f, § 7.

166. Treas. Reg. § 301.7701-2(a)(1)(1977)(characteristics of corporations).

167. *See* Rev. Rul. 75-67, 1975-1 C.B. 169.

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CONCLUSION

The problems discussed likely may be encountered twice: first before the corporation is formed, and again, when a problem arises and the need for a previously prepared solution is encountered. Advisors should carefully explore, in detail, each problem area to determine whether incorporation is advisable for the individuals involved. There is much less room for compromise in decision making by a corporate board of directors than there is in negotiations between individuals. Often a majority of a corporate board or shareholders can simply impose its uncompromised will upon a minority. The ill will and animosity that results if different goals are not settled before actual incorporation usually results in later difficulties for both the professional practice and the professional's relationship with the attorney-advisor involved.

POSTSCRIPT

At the time this article was sent to press, the Revenue Act of 1978 had been passed by Congress and sent to the President. It was not known, however, whether the President would sign or veto the Act. Therefore, the article does not reflect changes that were made in the Internal Revenue Code by the Act. If the Act is signed into law, certain provisions will change or modify some of the tax considerations and consequences discussed in this article.[168]

168. Some areas affected are medical reimbursement plans, "section 1244" stocks, assumption of accounts payable on incorporation of a going business, and the corporate tax rate structure.

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