Taxation: Current Status of Professional Corporations

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cedural right to file charges with the Board which is unaffected by the proviso to section 8(b)(1)(A). Even assuming that the right to file charges with the Board is an “exercise” of a section 7 right and thus subject to the restrictions of the proviso, an examination of the rationale of the proviso as it relates to section 7 reveals that Congress intended to provide immediate access to the Board for union members who allege section 7 violations. That section simultaneously grants to members the right to participate in various organizational and bargaining activities and preserves the right to refrain from such participation. However, individual members must necessarily waive some of these rights if the union is to perform its proper function as an economic bargaining unit. To this end the proviso permits unions to employ peaceful disciplinary techniques to further the achievement of goals established by the majority of the union. However, in the instant case, there is no legitimate group interest in restricting the union member’s access to the Board.

The interests of the union member would be best implemented by the Detroy interpretation of section 101(a)(4) and an interpretation of section 8(b)(1)(A) which provides an immediate right of access to the Board for members claiming section 7 violations. If the Detroy interpretation of section 101(a)(4) were adopted, additional protection of the union member under section 8(b)(1)(A) would not be absolutely necessary. However, the remedy offered by section 101(a)(4) has been criticized as illusory because of the expense of filing an individual suit in federal court, whereas the N.L.R.B. assumes the expense of a section 8(b)(1)(A) suit, thus offering a more realistic means of redress.

Taxation: Current Status of Professional Corporations

Plaintiff, an employee-stockholder of an incorporated Colorado law firm, sought a refund on personal income taxes paid on income from the firm’s professional services. The firm was incorporated under Colorado’s general incorporation laws and consisted of four lawyers. Each had an employment contract stipulating salary and agreeing to corporate direction as to clients and work loads. They also

28. In all Title I proceedings, the plaintiff must retain his own attorney, and these expenditures are not recoverable. See Klein, UAW Public Review Board Report, 18 Rutgers L. Rev. 304, 341 (1964).

1. 1 COLO. REV. STAT. ANN. ch. 22, Rule 265. The firm was incorporated under Colorado’s general incorporation laws and consisted of four lawyers. Each had an employment contract stipulating salary and agreeing to corporate direction as to clients and work loads. They also
on undistributed corporate income. The district court held that the corporation, duly authorized under Colorado law and possessing the prerequisite corporate characteristics, was of such a nature as to be classified as a corporation for federal income tax purposes. *Empey v. United States*, 272 F. Supp. 851 (D. Colo. 1967).

Federal judicial determination of corporate tax status for professional organizations is significant because of the tax advantages which it confers upon both the organization and its individual members. Such a determination depends upon the relevant treasury regulations which are interpretations of the 1954 Code provisions defining "partnership and partner" and "corporation." These definitions are derived from earlier Code provisions which date back to the Revenue Act of 1932.

Judicial decision has played a major role in defining the scope of these treasury regulations. Analyzing a trust in terms of its corporate characteristics, the Supreme Court in *Morrissey v. Commissioner* stated that an organization is an association, entered into a stock redemption agreement, which gave the corporation an option to buy the stock, after which it could be sold to any qualified practitioner. The corporation carried malpractice insurance for its employees, as required, and otherwise carried out the responsibilities of a corporate entity. Statement of Agreed Facts, *Empey v. United States*, 272 F. Supp. 851 (D. Colo. 1967).


Pension, profit-sharing, and annuity plans are granted to the employed but not to the self-employed. The usual course has been to incorporate to obtain these advantages, but this avenue has been denied to professionals because of various state laws which govern professional practice. Alternative plans are available for the self-employed person under the Keogh Plan, INT. REV. CODE OF 1954, §§ 72(n), 401(a), 401(c)-(g), 404(a) (8), 404(c), 404(f), 405, 503(j). See Eaton, *Professional Associations as Planning Techniques*, N.Y.U. 24TH INST. ON FED. TAX. 671 (1966); Reichler, *New Developments Under H.R. 10*, N.Y.U. 24TH INST. ON FED. TAX. 687 (1966); Snyder & Weckstein, *Quasi-Corporations, Quasi-Employees and Quasi-Tax Relief for Professional Persons*, 48 CORNELL L.Q. 613 (1963).

3. INT. REV. CODE OF 1954, § 7701(a) (2).
4. INT. REV. CODE OF 1954, § 7701(a) (3).
5. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 624-29 (1965). There is a lack of criteria within the statute by which to judge corporate classification. Since congressional intent in early years was to let local labels suffice, while current federal practice demands federal characterization for federal tax purposes, any result is possible. Id. at 622. See also J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 38.02 (1967).
6. 296 U.S. 344 (1935). The corporate characteristics relied on by the court were: formation by associates with a business objective, centralization of title, centralized management, continuity of life through
and therefore taxable as a corporation, if it merely resembles a corporation; it need not be identical to one. Subsequently, in *Pelton v. Commissioner,* the circuit court, using the corporate resemblance test, conferred association status upon a medical group, despite the existence of a state law which forbade the practice of medicine by corporations. In both *Pelton* and *Morrissey* the Commissioner argued for the classification of borderline cases as associations. However, when numerous groups attempted to achieve association status and the accompanying benefits, the possibility of revenue loss caused the Commissioner to reverse his position. The courts have not generally supported this position.

*United States v. Kintner,* decided in 1954, presented the case of a medical group classified under Montana law as a partnership. The court of appeals, finding that the clinic was more like a corporation than a partnership, held the group to be an association in spite of the fact that a corporation could not legally practice medicine in that state. Rejecting the Commissioner's argument that state classification should be binding, the court stated that this approach would introduce inconsistency and uncertainty in the application of the regulations among the states, and would ignore the position of the regulations that a self-perpetuating body, and free transfer of shares. 296 U.S. at 359. As the Code definitions of corporation, association, and partnership did not change from the 1932 Act to the 1954 Code, the *Morrissey* decision is arguably good law. See *Int. Rev. Code of 1954,* § 7701(a). See also *Swanson v. Commissioner,* 296 U.S. 362 (1935); *Helvering v. Como,* 296 U.S. 365 (1935); *Helvering v. Coleman–Gilbert,* 296 U.S. 369 (1935). In all three cases, although the Court found deficiencies in the creation and operation of the respective trusts, association status was granted.

7. 296 U.S. at 357.
8. 82 F.2d 473 (7th Cir. 1936).
11. 216 F.2d 418 (9th Cir. 1954), *affg* 107 F. Supp. 976 (D. Mont. 1952).
12. *Id.* at 422. In *Kintner* management was provided by an executive committee with fixed salaries for the members and provisions for any surplus to be divided proportionately. By agreement, the members limited liability to third parties only for their own personal misconduct. During the clinic's operation, it provided the doctors with all goods and services necessary for their practice. *Id.* at 420–21.
After hesitation, the Treasury responded with the *Kintner* regulations, which redefined associations and placed emphasis upon the determination by state law of the type of business form involved. The determinative factor in these regulations was not the nomenclature of the state law, but rather the restrictions which state law commonly placed on such groups giving them noncorporate characteristics. In addition, these regulations enumerated corporate characteristics to be met by associations wishing to be taxed as corporations: 1) associates, 2) business objective, 3) continuity of life, 4) centralized management, 5) free transferability of interests, and 6) limited liability. To be classified as an association, a group had to evidence more corporate than noncorporate characteristics, excluding the requirements of associates and business objective as determining factors, since these are characteristics met by all entities of a business nature other than the sole proprietorship. Therefore, under this regulatory scheme, an association had the burden of showing it possessed three out of the four remaining characteristics to be classified as an association. Because professionals were unable to incorporate under the laws of most states, this approach prevented most professionals and their groups from attaining corporate tax status and the resulting individual benefits.

However, the emphasis on the characteristics given to an organization by state law at the time of the business formation provided a means for professionals to obtain the desired tax benefits through a change in state law permitting professional incorporation. Such action would change the facts of practice suffi-

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14. Until the *Kintner* regulations were adopted, the Treasury's position was that the *Kintner* case itself would not be accepted as precedent by the Internal Revenue Service. Rev. Rul. 56-23, 1956-1 Cum. Bull. 598.


17. Treas. Reg. §§ 301.7701-2(a) (1)–(3) (1960). The effect of these sections is to give all the required characteristics equal weight in the determination of classification. Scallen, *supra* note 5, at 715.


ciently\(^2\) to meet the federal requirement by removing traditional disabilities and allowing the professional the same choice of business form as allowed his counterpart in other fields. Resulting enabling legislation which permitted lawyers to incorporate consisted, in most states, of authorization of various forms of professional associations or corporations.\(^2\) The solution in Colorado was a revision in the rules of civil procedure by the supreme court.\(^2\)

In response to such legislation, the Treasury in 1965 adopted additional regulations for the classification of professional service organizations.\(^3\) The new regulations provide for corporate

\(^2\) See Deering, Incorporation By Attorneys, 42 Ore. L. Rev. 93 (1963).


It was provided that shareholders must be lawyers licensed by the supreme court, owning the shares in their own right. Further, they must be actively engaged in the practice of law in the offices of the corporation. 1 Colo. Rev. Stat. ch. 22, Rule 265, at I.(D). Persons who become ineligible to hold shares must dispose of the shares either to the corporation or to someone with the proper qualifications. Id. at I.(E).

The president must be a shareholder and a director. To the extent possible, all other directors and officers must be lawyers licensed by the Supreme Court of Colorado. In any event, lay officers and directors may not exercise any authority over professional matters. Id. at I.(F).

The articles of incorporation must provide that all shareholders are jointly and severally liable or jointly and severally liable except when lawyers' professional liability insurance is maintained. Fifty thousand dollars insurance per attorney in the firm is required up to $900,000. Id. at I.(G). Personal liability to the bar is retained as to conduct and discipline. Id. at I.(H).


The reason given for the creation of this new classification and category was that with the use of the corporate form by professionals, the services rendered were not the type usually associated with corporations or associations. See Brief of Defendant, at 18. But see Foreman v. United States, 232 F. Supp. 134, 137 (S.D. Fla. 1964). Concluding that a personal service income was of a type not normally earned by a corporation, the court in Foreman labeled the government's argument a fallacy in light of the large number of personal service groups in the economy. The court commented that to its knowledge the corporate tax status of advertising, sales, promotion, and secretarial service groups, among others, had never been questioned.
classification of professional service organizations, including those called corporations under state law, only if they possess enough corporate characteristics to be classified as such under the Kintner regulations. Further provisions deal with the Morrissey characteristics and their strict application to the professional service corporation or association. Though in no case has a corporation classified as such by the states been held to be otherwise by the courts, the regulations still require an examination of these groups. The instant case is the first case testing the state enabling legislation and the federal regulations as recently amended.

The government's position in the instant case was that while local law controlled the determination of the legal relationships in form, the federal standard provided by the regulations must be met for determining federal taxation. The government asserted that the association must therefore possess the required corporate characteristics or it will be classified as a partnership. The Colorado firm's characteristics were then compared with the regulation's requirements, including the recent elaborations for the professional category, in an attempt to show no change in the firm's operation as a partnership. The regulations themselves were defended as possessing the force of law, written as reasonable interpretations of the Code.

The plaintiff attacked the regulations on the ground that the Code definition of partnership precluded an attempt to include a de jure corporation in the partnership category of taxation. He cited Pelton v. Commissioner in opposition to the government's theory that a professional service corporation is essentially noncorporate to such a degree as to warrant a different tax result. The plaintiff also pointed out that the corporate characteristics existed, that the firm operated as a valid

25. In addition to the Kintner regulations, the professional service associations must now meet further tests. Treas. Reg. §§ 301.7701(h) (1)-(5) (1965).
26. See Bittker, supra note 21, at 26.
28. Id. The regulations state in § 301.7701-3 that "[t]he term 'partnership' is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships."
29. Brief of Defendant, at 17.
30. Id. at 55.
31. Id. at 56, citing Maryland Cas. Co. v. United States, 251 U.S. 342, 349 (1920).
32. Brief of Plaintiff, at 11.
33. 82 F.2d 473 (7th Cir. 1936).
corporate entity, and that the restrictions placed on the corporation by the Colorado Supreme Court in its rule of civil procedure did not affect the corporate status and the resulting legal rights and duties.  

After noting that the regulations demanded a search of characteristics even for this formally chartered corporation, the court determined that the regulations placing this organization in the partnership class were inconsistent with the definition of partnership in the Code. The court stated that the Code's use of "other unincorporated organization" as coming within the definition of partnership was enough to necessarily exclude corporate bodies, thereby rendering the regulations invalid. The court also noted that there was no authority to extend the partnership concept to such an encompassing degree or to preclude corporate classification of professionals because of the nature of their services or their professional relation to clients.

The court also found that the firm more nearly resembled a corporation than a partnership, and thus, even if the regulations were to apply, the firm would still be entitled to its requested tax status. Due in part to the decision to use the Morrissey test of corporate resemblance, the court did not elaborate on the possession of the required characteristics. Concluding that the corporation possessed these characteristics, and that it was formally incorporated, the court held that the plaintiff was entitled to a refund of income tax paid.

While viewing the problem from the standpoint of association and corporate characteristics, the court mentioned state incorporation as an element in the determination of sufficient corporate characteristics. Thus, state law has apparently influenced the tax result for professionals—a result disapproved by the prior cases as introducing uncertainty in taxation. However, if prior decisions testing associations are valid, corporate tax sta-

34. Brief of Plaintiff, at 25.
36. Id.
37. Id. at 854.
38. See Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959). The court in Galt stated:

We think the association was entitled to be treated for tax purposes as though it was a corporation and the act of a state can neither raise nor lower the federal taxes that may be due by the association by whatever name it may be called under the laws of the particular state.

Id. at 362; see also Kintner v. United States, 216 F.2d 418, 424 (9th Cir. 1954).
tus is a federal question, and state incorporation is not determinative. Yet by allowing states to remove local disabilities as to choice of business forms for various types of businessmen within their jurisdiction, certainty is arguably served when the decision as to taxation on the federal level is one of classification of groups which possess elements which clearly evidence a reason for different tax treatment.

Because the problem of association has never been decided by using a test based on the formal incorporation of the entity, the court in Empey freely relied upon the corporate resemblance test. By first declaring the Treasury's regulatory scheme to be invalid, the court avoided detailed consideration of the resemblance test as outlined in Morrissey. However, the Morrissey tests have not been previously used to determine the tax status of a de jure corporation. Thus, the existence of state incorporation provisions would seem to call for a more succinct discussion of the characteristics which are present and their relevance to the tax consequences. In addition, the fact that the legislation in this area has been passed primarily to help professionals avoid tax consequences should arguably require an examination into the substance of the organization. The brevity of the opinion in Empey does not satisfy either these questions or deal with the issue of the Commissioner's power to go beyond the state incorporation statutes in defining corporate tax status.

While the instant case is a step toward allowing a taxpayer

39. See Bittker, supra note 21, at 28-30.
40. See Anderson, supra note 2, at 317-22. In other tax areas the corporateness of an entity is generally not questioned. The entity itself, and its reasons for existence are usually accepted after being chartered under state law, thus causing the entity to come into being for tax purposes. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943). However, the corporation must intend to carry on business and actually do so. See Tomlinson v. Miles, 316 F.2d 710, 713-14 (5th Cir. 1963).

The entity itself can be ignored when it is a fiction or a sham, as when it is operating as a true agent or as a fraud on the tax statutes. However, it is then destroyed altogether for failure to carry out a true business purpose, rather than for failure to meet a federal requirement regarding incorporation standards. See National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Continental Oil Co. v. Jones, 113 F.2d 557 (10th Cir. 1940).

42. A legal transaction will not be denied effect because of a tax motive, but it may be examined to see if it is in reality what it appears to be; substance, not form, is controlling. Morsman v. Commissioner, 90 F.2d 18, 22 (8th Cir. 1937).