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Taxation--Professional Corporations--IRS Recognizes Corporate Status (Technical Information Release No. 1019, August 19, 1969)

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unfortunately not in a climate unfavorable to such a continued evolution in our criminal law. The incompatibility of this decision with the equal protection clause, the due process clause, and the double jeopardy clause of the Constitution is obvious, and awaits the greater influence of a more enlightened philosophy of criminal justice.

TAXATION — PROFESSIONAL CORPORATIONS — IRS RECOGNIZES CORPORATE STATUS. — *Technical Information Release No. 1019, 2 CCH Corporation Law Guide ¶ 11,482 (August 19, 1969).*

Although courts have attempted to define corporate status since *Trustees of Dartmouth College v. Woodward*,[1] the issue seems to have arisen in a tax context only since the passage of the Revenue Act of 1894.[2] Subsequently, Congress sought to provide legislative guidelines for the determination of corporate status for federal tax purposes.[3] Unfortunately, however, each of these attempts proved unsuccessful; the meaning of the term "corporation" remained uncertain. More importantly, the relationship between state incorporation statutes and corporate status under federal income tax legislation was never explored. Nevertheless, there seemed to be little difficulty in the tax treatment of corporations designated as such.

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1 17 U.S. (4 Wheat.) 518 (1819), wherein Chief Justice John Marshall defined a corporation as follows:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property, without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men, in succession, with these qualities and capacities, that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal being.

Id. at 636.

2 Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556. While exempting partnerships, this Act treated corporations and associations alike by imposing a 2 percent tax on their income. The legislative history preceding passage of this Act indicates a distinction between corporations and associations on the one hand, and partnerships on the other. 26 CONG. REC. 6866, 6867 (1894) (remarks of Mr. Hoar). Furthermore, the debates reveal some sentiment for treating associations organized under state law as "quasi-corporations." *Id.* at 6833 (remarks of Mr. Vest).

3 *See, e.g.*, Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057. The congressional debates preceding the passage of the Act indicate that the term "corporation" included associations, which were defined as a number of people associated together whether or not

Indeed, this area was notable for its lack of controversy until *Morrissey v. Commissioner*[4] was decided in 1955. In *Morrissey* the Government attempted to impose corporate status upon a real estate trust. The Commissioner sought to continue the prevailing practice[5] of characterizing organizations whose status was in doubt, *i.e.*, business trusts, as associations, which were treated as corporations for federal income tax purposes.[6] The United States Supreme Court adopted his contentions, holding that a trust, although not incorporated under state law, should be taxed as a corporation since it possessed more of the attributes or characteristics of a corporation than a non-corporation.[7]

Although *Morrissey* is cited as leading authority in determining whether an entity should be treated as a corporation for tax purposes, it is *Pelton v. Commissioner*[8] which is of primary interest in the

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they were incorporated. Revenue Act of 1932, ch. 209, § 1111, 47 Stat. 289. *See, e.g.*, 56 CONG. REC. 10,418 (1918) (remarks of Mr. Garner). Thus, it is interesting to note that the 1918 Act defined the term "corporation" in a manner substantially similar to that of the present code. It was this Act which distinguished personal service corporations from other corporations and treated them as partnerships, although this special treatment was to have effect for only three years. Today, the definition of the term "corporation" is contained in section 7701 of the 1954 Code:

> § 7701. Definitions
> (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—
> (1) Person.—The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.
> (2) Partnership and partner.—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.
> (3) Corporation.—The term "corporation" includes associations, joint-stock companies, and insurance companies.
> (b) Includes and Including.—The terms "includes" and "including" when used in a definition contained in this title shall not be deemed to exclude other things otherwise within the meaning of the term defined.

INT. REV. CODE OF 1954, § 7701(a)(1)-(3), (b).

4 296 U.S. 344 (1935).

5 *See* Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 640, 653-57 (1965).

6 *See* note 2 *supra*; Comment, *Can Professionals Incorporate for Tax Purposes?*, 33 ALBANY L. REV. 311, 314 (1969).

7 The *Morrissey* Court found a trust analogous to a corporate organization for federal tax purposes when the following criteria were satisfied:
(1) the "corporation, as an entity, holds the title to the property,"
(2) "centralized management through representatives of members of the corporation,"
(3) security from "termination or interruption by the death of owners of beneficial interests,"
(4) "[transferability of] beneficial interests without affecting the continuity of the enterprise," and
(5) "limitation of the personal liability of participants to the property embarked in the undertaking." 296 U.S. at 359.

8 82 F.2d 473 (7th Cir. 1936).

context of professional associations. There, the court, adopting the *Morrissey* rationale, imposed what has come to be termed the "preponderance of attributes" or "substantial resemblances"[9] measure to a group of physicians operating a clinic as a trust. Thus, it was determined that a trust composed entirely of professionals could be treated as an association, and hence, taxed as a corporation.

Subsequent to the *Pelton* case, the economic philosophy underlying federal tax legislation underwent significant alteration. While prior tax treatment of corporations had generally been more onerous than that of partnerships and individuals,[10] Congress deviated from this course of conduct in 1938 when it imposed a flat tax rate of 20 percent on net corporate income in excess of $25,000.[11] This new rate, representing a 40 percent reduction in the maximum tax rate of such corporations,[12] when supplemented by a sharply rising progressive tax rate on individual income,[13] soon demonstrated the advantages of corporate tax treatment.

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9 *Id.* at 476.

10 Act of Aug. 27, 1894, ch. 349, §§ 27, 32, 28 Stat. 553, 556. This Act imposed a 2 percent tax on corporate and individual income, but exempted $4,000 of individual and partnership income from taxation. The Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 112, placed a 1 percent tax on net income over $5,000 for every corporation and association. Partnerships were excluded from the effects of this tax.

11 1939-1 CUM. BULL. 730, pt. II.

12 *Id.*

13 Revenue Act of 1942, ch. 619, § 103, 56 Stat. 802-03. The double taxation provision applicable to corporate income (taxation of income as it accrues to the corporation and taxation of shareholders' income received in the form of salary and dividends) which initially made the corporate tax burden more onerous, has been mitigated by the different tax rates applicable to partnerships and corporations, and by the availability of certain deductions discussed below. While a partner is taxed at the progressive personal income tax rate, even on undistributed income of the partnership, a corporate employee would pay the personal tax rate only on salary and income that was actually distributed to him. Though the corporation would be taxed on its income, it is taxed at a lower rate—22 percent of its income up to $25,000 and 48 percent of its income above this amount. *See* Comment, *Tax Relief for Professional Service Organizations*, 73 DICK. L. REV. 486 (1969). By the device of an employment contract, an employee can spread his income over a lifetime, thus avoiding a high tax rate in a few high income producing years. *See* Scallen, *supra* note 5, at 604 n.3. Deferral of taxation can also be accomplished through pension or profit sharing plans, INT. REV. CODE OF 1954, §§ 401-07, whereby the corporation may deduct its contribution to the plan even though the employee is not taxed on the contribution until it is actually distributed to him. *Id.* §§ 402-(a)(1), 406(a). Although Congress has enacted a similar plan for self-employed individuals and partnerships, it is not as advantageous as the corporate plan. *See* Comment, *supra*, at 487-88; Comment, *supra* note 6, at 313. A corporation may purchase group life, accident, disability, medical and hospital insurance for its employees, and deduct such premiums when computing its federal income taxes without the employees being taxed on the premiums paid for them. INT. REV. CODE of 1954, §§ 105(d), 106; Treas. Reg. §§ 1.61-.2(d)(2). T.D. 6272, 11-25-57, 1966-2 CUM. BULL. 23-24. Similarly, corporations may establish death benefit plans whereby an employee's widow will receive up to $5,000 which is not taxable as income to her, but can be deducted by

This economic incentive was readily discernible in *United States v. Kintner*,[14] wherein the roles of the Commissioner and the taxpayer were reversed on the question of taxing noncorporate entities as corporations. Prior to 1948, plaintiff physician had practiced as a member of a partnership; however, in that year, the partnership was dissolved and the partners executed "Articles of Association," providing that "the members 'associate themselves together for the practice of medicine and surgery as an unincorporated association', which was to be endowed with the 'attributes of a corporation' and to be 'treated as a corporation for the purposes of taxation.' "[15] The Commissioner, resisting the application of such advantageous corporate tax treatment to an unincorporated business, entered a deficiency determination against the plaintiffs. The taxpayers then instituted an action in the District Court of Montana seeking to recover that deficiency assessment. The Commissioner responded with the identical argument advanced by the physicians in *Pelton*: since doctors were unable to incorporate under state law, their association could not be regarded as a corporation under federal income tax legislation.[16] The district court rejected this contention,[17] and on appeal, the Ninth Circuit affirmed, admitting:

> The laws of Montana do not include the practice of medicine as one of the purposes for which a corporation may be organized. Montana Civil Code, 1935, Sec. 5902. And it may be assumed that its courts would infer from this statute an intention to prohibit a corporation from practicing medicine.[18]

However, rejecting the argument that local law should govern, the court applied the criteria enunciated in *Morrissey* and held that a qualifying association would be treated as a corporation.[19]

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the corporation. INT. REV. CODE of 1954, § 402(a)(2). In addition, corporate employees are covered by Workmen's Compensation, the income of which is tax free. *See* Brief for Medical Group Management Association as Amicus Curiae at 3, O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969).

14 216 F.2d 418 (9th Cir. 1954).

15 *Id.* at 420.

16 *Id.* at 421-22. *See also* Scallen *supra* note 5, at 639-40.

17 107 F. Supp. 976 (D. Mont. 1952).

18 216 F.2d at 421.

19 *Id.* at 422. Quoting the *Pelton* court, it stated:

> It is obvious from this record that petitioners' enterprise was carried on for profit, and it is likewise clear that all the substantial points of resemblance to a corporation as specified in the decisions mentioned were present in their organization. On the other hand, substantial dissimilarities to the partnership form appear. Petitioners have called our attention to a recent decision of the Illinois Supreme Court, People [by Kerner] v. United Medical Service, 362 Ill. 442, 200 N.E. 157, in which it was held that a corporation may not practice medicine in Illinois. However, we think that Article 1503 of Regulations 65 and 69 sufficiently covers

In response to this judicial setback, the Commissioner, in an obvious effort to discourage professional incorporation as an avoidance device,[20] promulgated the Kintner Regulations.[21] The applicable portions of these Regulations provide:

> Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, *it is local law which must be applied* in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.[22]

The Commissioner then enumerated specific standards[23] which were

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this situation in providing that "organizations . . . are . . . associations within the meaning of the statute even though under state law such organizations are technically partnerships.

Id., *quoting* 82 F.2d at 476.

Additionally, the Government's position was undermined by its own regulations. *See, e.g.*, Treas. Reg. 86, art. 801-1 (1935); Treas. Reg. III, §§ 29.3797-2, 29.3797-4(1949). Of particular note are the Treasury Regulations applicable to the definition of an "association." The term "association" is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. Treas. Reg. III, § 29.3797-2 (1949). In regard to partnerships, the Regulations provided:

> If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their respective capacities, such an organization is an association, taxable as a corporation.

Id. § 29.3797-4.

Thus it is apparent that the only criteria separating partnerships from associations were continuity of existence and centralization of management. *See* Scallen, *supra* note 5, at 662, 664. The Articles of Association in *Kintner* seemed designed to meet these criteria. 216 F.2d at 420. *See also* Commissioner v. Fortney Oil Co., 125 F.2d 995 (6th Cir. 1942).

[20] *See* note 23 *infra*.

[21] Treas. Reg. §§ 301.7701-1-301.7701-11 (1960).

[22] *Id.* § 301.7701-1(c) (emphasis added). It is interesting to note that the *Kintner* court, in rejecting the Commissioner's contentions regarding state law, had stated:

> It should be added that it would introduce an anarchic element in federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system,—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence.

216 F.2d at 424.

[23] The characteristics which an unincorporated organization must possess in order

to be utilized in determining whether the organization in question contained "more corporate characteristics than noncorporate characteristics."[24] Additionally, the Regulations provided that characteristics common to both corporate and noncorporate entities should not be considered in determining whether a particular organization qualified for corporate tax treatment.[25]

Professional groups, recognizing the stringency of these Regulations,[26] responded by inducing state legislatures to enact either a professional corporation or professional association act.[27] Although such acts present two different routes to the identical goal, the common aim has been to minimize taxes by seeking corporate status. In turn, the Commissioner, reversing his previous position on the matter of state law in an attempt to counteract such measures, promulgated certain

to achieve classification as a corporation for federal tax purposes are associates, an objective to carry on business and divide the gains therefrom, continuity of life, centralization of management, limited liability, and free transferability of interests. Treas. Reg. § 301.7701-2(a)(2)-(e) (1960).

[24] *Id.* § 301.7701-2(a)(3).

[25] Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit . . . the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

Id. § 301.7701-2(a)(2).

[26] As a result of the emphasis which the Kintner Regulations placed upon criteria applied technically under local law, it became impossible for an organization which was characterized as a partnership under local law to obtain corporate status under the federal income tax laws. Scallen, *supra* note 5, at 605. *But see* Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964).

[27] *See, e.g.*, FLA. STAT., ch. 621 (1966); GA. CODE ANN. §§ 84-4301-4318 (1968); OHIO REV. CODE ANN. §§ 1785.01-.02 (Page 1967). Forty-seven states have enacted professional service corporation or association laws for one or more professional groups. 7 CCH STAND. FED. TAX REP. ¶ 8094 (1969). *See also* Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961). Professor Bittker distinguishes between professional association statutes and professional corporation statutes. In discussing these statutes, Mr. Scallen distinguishes a third approach — that of Colorado, "where a rule of civil procedure provides that attorneys may practice in the corporate form . . . ." Scallen, *supra* note 5, at 609.

amendments to the Kintner Regulations.[28] In pertinent part they provide:

> [T]he labels applied by local law to organizations, which may now or hereafter may be authorized by local law, are in and of themselves of no importance in the classification of such organizations for the purposes of classification under the Internal Revenue Code.[29]

Additionally, the amendments sought to establish separate criteria for professional service organizations.[30]

As a consequence of the amended Regulations, a substantial body of case law began to evolve.[31] In *Empey v. United States*[32] a group of attorneys utilized a Colorado Rule of Civil Procedure[33] to organize a professional service corporation under the Colorado Corporation Code.[34] Although Empey, a member of the corporation, initially had paid his taxes as if it were a partnership, he subsequently filed a claim for a refund of the tax. When the Commissioner failed to take any action on the claim within six months after it was filed, Empey commenced this action.[35] The trial court found for the plaintiff, holding that the Regulations involved were inconsistent with the statutory definition of corporations and partnerships and the judicial construction thereof. Moreover, as the Regulations constituted the exercise of a nondelegable legislative function, they were invalid and unenforceable. Finally, the court held that even if the Regulations were valid, the organization in question more nearly resembled a corporation than a partnership. On appeal, the Tenth Circuit affirmed, stating:

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28 Treas. Reg. § 301.7701-2(d), (g)-(h) (1965).

29 *Id.* at § 301.7701-1(c). *Cf.* note 20 *supra* and accompanying text.

30 *Id.* at § 301.7701-2(h). This criteria rendered it practically impossible for a professional association to qualify as a corporation for federal tax purposes. For example, Treas. Reg. § 301.7701-1(h)(2) (1965) provides that a professional service organization lacks

> continuity of life within the meaning of paragraph (b) of this section if the death, insanity, bankruptcy, retirement, resignation, expulsion, professional disqualification, or election to inconsistent public office of any member will (determined without regard to any agreement among the members) cause under local law the dissolution of the organization.

Similarly, subsection (h)(4) provides:

> If under local law and the rules pertaining to professional practice, a mutual agency relationship, similar to that existing in an ordinary professional partnership, exists between the members of a professional service organization, such organization lacks the corporate characteristic of limited liability.

31 *See* note 52 *infra.*

32 406 F.2d 157 (10th Cir. 1969). For an interesting treatment of *Empey*, see Ray, *Court Upholds Professional Corporation: Kintner Regulations Declared Invalid,* 27 J. TAX. 270 (1967).

33 COLO. R. CIV. P. 265.

34 COLO. REV. STAT. ANN. art. 1-10 (1963).

35 272 F. Supp. 851 (D. Colo. 1967).

> There has been no substantial change in the definition of the term "corporation" and the term "partnership" since the Revenue Act of 1932, and the definitions of those terms in the Internal Revenue Code of 1954 are identical with their definitions in the Revenue Act of 1939. The definition of a partnership, by its language, plainly refers to unincorporated organizations. To treat as a partnership for federal income tax purposes a corporation, organized and chartered under state laws as a corporation and operated as such in good faith, does violence to the statutory definitions of the terms "partnership" and "corporation," to long followed administrative practice prior to 1965, and to the decided cases dealing with analogous organizations. Moreover, Congress has not seen fit to take any legislative action to overturn such long standing practices and decisions, and the Treasury Department only undertook to do so by a greatly belated Regulation.
>
> We conclude the 1965 Regulations are "unreasonable and plainly inconsistent with the revenue statutes," and are therefore invalid. Moreover, we think the 1965 Regulations "amount to an attempt to legislate" and are therefore invalid.[36]

In *Kurzner v. United States*,[37] the Fifth Circuit applied the "preponderance of attributes" test under the original Kintner Regulations to a substantially similar situation. Since the medical group seeking status as a corporation for tax purposes satisfied the criteria established by these Regulations, the result was identical to *Empey*. In addition, however, the *Kurzner* court found the 1965 amendments invalid as "bold attempts . . . to avoid judicial decisions . . . [and] arbitrary, discriminatory, and legislative in nature."[38]

In their successful challenges to the Kintner amendments both *Empey* and *Kurzner* relied upon state incorporation acts. However, in *O'Neill v. United States*,[39] the petitioners were organized under a state *association* act. Plaintiff O'Neill was a shareholder, director and employee of Drs. Hill and Thomas Company, a medical association which had practiced in the partnership form for fifty-five years, but was reorganized in 1963 as an association under the Ohio Professional Associations Act.[40] In his return for the fiscal year ending January 31,

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36 406 F.2d at 170 (footnotes omitted). The court cited both Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948), and Helvering v. Sabine Transp. Co., 318 U.S. 306, 311-12 (1943).

37 CCH 1969 STAND. FED. TAX REP., U.S. TAX CAS. (69-1, at 84, 765) ¶ 9428 (5th Cir. May 27, 1969).

38 *Id.* at 84,777.

39 410 F.2d 888 (6th Cir. 1969). *See also* Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968), wherein a medical association organized under the Georgia Professional Associations Act, GA. CODE ANN. ch. 84-43 (1961), was regarded as possessing the necessary attributes to qualify as a "corporation" for federal tax purposes.

40 OHIO REV. CODE ANN. §§ 1785.01-.08 (Page 1964). Section 1785.08 incorporates by

1966, the taxpayer reported and paid taxes on the amount of income of the company which would have been taxable to him had it been a partnership. When his timely claim for refund was not granted, the taxpayer commenced this action in the district court. Characterizing Treasury Regulation § 301.7701-2(h) as an administrative overreaching without support in the law, that court entered judgment for the taxpayer, concluding that under Regulation § 301.7701-2(a-f) the company was a corporation for federal tax purposes.[41] And it was further held that the company should be regarded as a corporation under Ohio law.[42]

On appeal, the Sixth Circuit affirmed, stating that the primary issue was one of statutory construction:

> Did Congress in the statutes from 1918 to the present, when it used identical language with respect to the term "corporation," mean that some state chartered corporations should not be treated as corporations for federal income tax purposes?[43]

The Government argued that in order to be a corporation for federal tax purposes a state chartered corporation must be tested against the criteria established in *Morrissey*. The court, carefully distinguishing *Morrissey*, rejected this contention:

> In *Morrissey* the question was whether a trust created for the development of a tract of land was an "association" under federal tax law and hence taxable as a corporation. The Court was not called on to define a corporation for purposes of federal taxation. Since the Court was not defining the word "corporation" and was dealing with a trust, it did not mention such characteristics of a corporation as existence by virtue of a charter granted by the sovereign, status as a legal entity separate from its owners, and being a person in contemplation of law.
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> . . . .
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> . . . The *Morrissey* case did not deal with the definition of "corporation" under the statute, and we hold that it in no way supports the position of the Government that a corporation under state law must meet a test of resemblance to some federal standard of

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reference chapter 1701 of the General Corporation Law, insofar as it does not conflict with the Professional Association Law.

Drs. Hill & Thomas Company provided in its articles of association that (1) shares of the company were limited to licensed physicians, (2) shares could be transferred only with written consent of the company, and (3) upon termination of employment, all outstanding shares would be offered to the company. 410 F.2d at 898-99.

41 281 F. Supp. 359 (N.D. Ohio 1968).

42 *Id.*

43 410 F.2d at 890.

corporateness, before it will be taxed as a corporation under federal law.[44]

The Government's reliance upon statutory definitions and legislative history was also rejected. In regard to the former, the court noted that since the enactment of the Revenue Act of 1919, the term "corporation" has encompassed "associations, joint-stock companies, and insurance companies."[45] Analogizing to the Code sections which afford special treatment to personal service corporations,[46] it contended that Congress intended that they be taxed as corporations unless otherwise explicitly provided.[47] And the legislative history was viewed as exhibiting a congressional intent to include within the term "corporation" all associations whether or not incorporated.[48]

The circuit court then examined the Government's reliance upon the "interpretive regulations" of the Treasury Department, noting that "not until the 1960 promulgation of Treasury Regulations § 301.7701-1(c) was there any indication that a state created corporate entity might not be a corporation under 26 U.S.C. § 7701(a)(3)."[49] It quickly rejected the Government's contention "that associations are taxed as corporations because they meet the test of 'associations' under federal tax law,"[50] and to the extent that the Regulations supported this position, characterized them as an invalid attempt to legislate.[51]

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44 *Id.* at 891.

45 Act of Feb. 24, 1919, ch. 18, § 1, 40 Stat. 1057, 1058 (now INT. REV. CODE of 1954, § 7701(a)(d)).

46 *See* Second Revenue Act of 1940, ch. 757, §§ 101, 725, 502, 54 Stat. 974, 987, 1005; Excess Profits Tax Act of 1950, ch. 1199, § 101, 64 Stat. 1137, 1176.

47 410 F.2d at 892.

48 *Id.* at 893-94. Similarly, the court stated that the history of the revenue acts failed to exhibit a congressional intent to exclude professional corporations or associations, as defined under state law, from the "corporation" definition of section 7701(a)(3). *Id.* at 894.

Statutory history also evidenced congressional recognition that corporations, state-created entities subject to no uniform law, would have varying characteristics, but made no provision that these different qualities would affect their status for tax purposes. *Id.* at 895.

49 410 F.2d at 894. *See* Bittker, *supra* note 27, at 25-26, wherein Professor Bittker discussed the possibility of applying the 1961 Regulations to organizations incorporated under state law.

> Do these "corporations" or "professional corporations" constitute "corporations" as this term is used in the Internal Revenue Code? To the best of my knowledge, this is a novel question in the sense that until now all organizations bearing the label "corporation" under state law have, without further inquiry, been accorded that status for federal income tax purposes, the only debate in this area having been concerned with the classification of organizations that are not labelled "corporations" by state law.

Id.

50 410 F.2d at 895. The court stated that "the absence of any indication that state law corporations would be treated as anything other than corporations for federal tax purposes may be taken as some indication that Congress used them as a definitional lodestar." *Id.*

51 *Id.* The court noted that "[t]he net effect of the Government's position with respect

The "labeling" argument advanced by the Government was perhaps its most persuasive.[52] The Government urged that federal taxation should not "turn on state labels attached to entities created under state law, since that would vitiate the 'substance over form' principle so firmly embedded in the law of federal taxation (see, e.g., Gregory v. Helvering, 293 U.S. 465 [55 S. Ct. 266, 79 L. Ed. 596]) and lead to rampant inequality of federal tax treatment."[53] It pointed out that several states had enacted professional association acts under which associations could not incorporate. Thus, two associations, identical in all other respects, could be accorded varying treatment under the federal income tax depending upon whether the particular state statute involved permitted incorporation by an association. The court responded by noting that "some [tax] inequities have existed for many years and Congress has seen fit to do nothing about them in terms of enacting a more precise definition of 'corporation'."[54] Additionally, the court observed:

> [T]he particular tax inequities of which the Government here complains may be regarded as a result of the 1960 and 1965 amendments to the Regulations which the Commissioner saw fit to adopt after United States v. Kintner, 216 F.2d 418 (9th Cir.), and the enactment of professional corporation and association statutes by some of the state legislatures.[55]

While refusing to characterize its holding as the adoption of a "labeling" approach, the court clearly stated that "the inquiry is whether the state granted existence to a corporate entity under its law."[56] The fact that the state limited the corporate properties which a professional association might possess was regarded as having no bearing under the Internal Revenue Code.[57] Consequently, the Government's contentions that the association lacked limited liability, freely transferable shares, centralization of management, and continuity of life were unavailing.[58] This rejection was consistent with the court's earlier treatment of *Morrissey*; federal standards of corporateness were not

to the Company in this case of course is to create an exemption from corporate taxation based on 26 U.S.C. § 7701(a)(3)." *Id.* at 895 n.12.

52 For the Government's "labeling" argument, which this author feels is a valid one, see Brief for Defendant-Appellant at 12-15, O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969).

53 410 F.2d at 897.

54 *Id.* at 898.

55 *Id.*

56 *Id.*

57 *Id.*

58 *Id.* at 898-99.

pertinent, the inquiry being limited to whether the association was a corporation under state law.[59] The court concluded:

> We hold that a corporation created under state law is a corporation within the meaning of 26 U.S.C. Sec. 7701(a)(3) and that Treas. Reg. Secs. 301.7701-1(c) and 301.7701-2 are invalid insofar as they require a corporation created under state law to be treated as something other than a corporation for federal tax purposes.[60]

One might cogently argue that the line of cases culminating in *O'Neill*[61] firmly established that the judiciary would not sanction discriminatory treatment of professional service organizations, and would continue to invalidate the Treasury Regulations where they resulted in a denial of the benefits of corporate tax status to those groups. However, subsequent to the Sixth Circuit's decision in *O'Neill*, the Internal Revenue Service's continued rejection of asserted corporate status for professional service organizations resulted in another series of court challenges to the Kintner Regulations.[62] Once again, the contention of the Commissioner that professional service organizations

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[59] *Id.* at 899. *See* note 44 *supra* and accompanying text. It is submitted that the court erred in terminating its inquiry at this point. The "preponderance of attributes" test should be an equal partner in arriving at a determination of whether an association such as was involved in *O'Neill* should be taxed as a corporation. Bittker, *supra* note 27, at 3, lends support to this contention. In distinguishing between professional corporations statutes and professional associations statutes, he classifies the Ohio statute in the latter category and states:

> [A]lthough some of the provisions of the state corporation laws are made applicable to these groups, they also bear some earmarks of unincorporated groups and their status under the Internal Revenue Code depends upon whether they are "associations" within the meaning of section 7701(a)(3).

See also Bittker, *Professional Service Organizations: A Reply*, 24 TAX L. REV. 300 (1969); Thies, *Professional Service Organizations: A Comment*, 24 TAX L. REV. 291 (1969).

[60] 410 F.2d at 899.

[61] Empey v. United States, 406 F.2d 157 (10th Cir. 1969) (attorneys incorporated under Colorado law held a corporation for tax purposes); Kurzner v. United States, CCH 1969 STAND. FED. TAX REP., U.S. TAX CAS. (69-1, at 84, 765) ¶ 9428 (5th Cir. May 27, 1969) (medical group incorporated under Florida Professional Service Corporation Act held to meet the corporate attributes of Treausry Regulations § 301.7702-2(a)-(g) and subsection (h) was struck down); Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968) (medical group formed under Arkansas Medical Corporation Act held to be entitled to tax treatment as a corporation); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968) (unincorporated medical group organized under the Georgia Professional Association Act held to meet the four basic criteria necessary for corporate tax status).

[62] Williams v. United States, CCH 1969 STAND FED. TAX REP., U.S. TAX CAS. (69-2, at 85,320) ¶ 9519 (D. Minn. July 1, 1969) (medical clinic organized under Minnesota law classified as a corporation for federal tax purposes); Ahola v. United States, CCH 1969 STAND. FED. TAX REP., U.S. TAX CAS. (69-2, at 85,323) ¶ 9520 (D. Minn. July 1, 1969) (medical clinic operating as a business trust held taxable as a corporation because it satisfied the Kintner Regulations' criteria for an association); Smith v. United States, CCH 1969 STAND. FED. TAX REP., U.S. TAX CAS. (69-1, at 84,889) ¶ 9360 (D. Fla. April 14, 1969) (medical group organized as a corporation under Florida law held taxable as such).

must meet the more stringent criteria of the Treasury Regulations was rejected by the courts.[63] Finally, as a result of the numerous decisions invalidating the so-called Kintner Regulations, the Service announced a change in policy, conceding that "organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes."[64] Under the abandoned approach, corporate status for federal

[63] *See* cases cited note 62 *supra*.

[64] Technical Information Release No. 1019, 2 CCH CORP. LAW GUIDE ¶ 11,482 (August 19, 1969). The full text of the statement by the Internal Revenue Service appears below.

> The Internal Revenue Service announced today, in response to recent decisions of the Federal courts, that it is conceding that organizations of doctors, lawyers, and other professional people organized under state professional association acts will, generally, be treated as corporations for tax purposes.
>
> This action followed a decision not to apply to the Supreme Court for certiorari in the recent cases of United States v. O'Neill [69-1 USTC ¶ 9372], F.2d (6th Cir., May 1, 1969), aff'g 281 F. Supp. 359 (N.D. Ohio 1968), and Kurzner v. United States [69-1 USTC ¶ 9428], F.2d (5th Cir., May 27, 1969) aff'g 286 F. Supp. 839 (S.D. Fla. 1968). This decision was made by the Solicitor General and concurred in by the Assistant Attorney General (Tax Division) and the Commissioner and Chief Counsel, Internal Revenue Service.
>
> Both of these decisions held that a group of doctors organized under state law was classifiable as a corporation for Federal tax purposes. Obviously, however, the government must reserve the right to conclude differently in any case that reflects special circumstances not present in *O'Neill* or *Kurzner*.
>
> An earlier decision had been made not to seek certiorari in U. S. v. Empey, holding a group of lawyers organized under the general corporation laws of Colorado to be a corporation for Federal tax purposes.
>
> Nor will the government further press its appeals presently pending in the 5th and 8th Circuits. These are respectively Holder v. United States [68-2 USTC ¶ 9504], 289 F. Supp. 160 (N.D. Georgia 1968), and Wallace v. United States [68-2 USTC ¶ 9669], 294 F. Supp. 1225 (E.D. Ark. 1968). Also, no appeal will be prosecuted in any other pending cases decided adversely to the government on the same issue involving similar facts. Finally, all similar cases now in litigation or under audit will be reviewed to see if they should be conceded.
>
> Implementing instructions will be issued to field personnel — if necessary on a state-by-state basis — as soon as possible. In addition, appropriate modifications of existing regulations will be required consistent with these decisions.

This development has extremely broad implications for the professional element in our society. The *New York Times* recently reported that "thousands of professional and small corporations are being sought eagerly by mutual funds, insurance companies and to a lesser extent by banks." Hershey, *Professions Win Incorporation Right*, N.Y. Times, Oct. 26, 1969, § 3 (Business and Finance), at 12, col. 5.

In addition, it has been reported that the Service has unofficially begun to accept applications for approval of "prototype" benefit plans. *Id.* A prototype, submitted by a sponsor organization, *e.g.*, a mutual fund or insurance company, once approved, enables a corporation to establish a qualified benefit plan by simply adopting and properly applying for it. Corporate employee-benefit plans, including pension and profit-sharing programs, are generally regarded as superior to plans authorized by the Self-Employed Individuals Retirement Act of 1962, commonly termed the Keogh Act, Pub. L. 87-799, Oct. 10, 1962, 76 Stat. 809, *as amended*, 26 U.S.C. §§ 37, 62, 72, 101, 104, 105, 172, 401-05, 503, 805, 1361, 2039, 2517, 3306, 3401, 6047, 7207 (1964). N.Y. Times, Oct. 26, 1969 § 3 (Business & Finance), at 12, col. 5. Under the latter program, a self-employed person is permitted to deduct contributions to his own pension plan up to 10 percent of his income.

tax purposes was conditioned upon possession of such corporate characteristics as a business purpose, continuity of life, centralized management, limited liability, and free transferability. Now, however, in the vast majority of cases, compliance by a professional group with appropriate state law will insure corporate treatment for tax purposes. Although the Service retains the right to contest the asserted corporate status of any group under *special* circumstances not present in *O'Neill*, it is safe to assume that Technical Information Release No. 1019 represents a basic shift in service policy, and henceforth, professional

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However, in no event can he deduct more than $2,500 per year. In addition, the taxpayer must contribute a similar percentage for workers employed on a full-time basis for three years. If a corporate plan is utilized, no dollar ceiling on contributions and deductions is imposed, "and there is no requirement for immediate and full vesting on behalf of covered employees." *Id.* at col. 6.

The benefits of incorporation were exemplified in a financial plan drawn up by a business management consultant for a client who specialized in internal medicine.

	Continuing in solo practice	As a corporation
Gross practice income for one year	$176,700	$ 176,700
Overhead costs	—53,000	—55,650
Amount deducted for tax-sheltered investment plan	— 2,500	—23,950
All forms of insurance deductible	* not allowed	— 1,297
Net practice income	$121,200	$ 95,800
Tax bracket	64%	60%
Federal tax paid	$ 64,180	$ 46,900
	(a tax savings of $17,280)	
Personal take-home pay	$ 57,020	$ 48,900
Deductible investments added back to indicate total personal income	+2,500	+23,950
Personal insurance	—1,297	* already paid and deducted
Net personal income (total assets)	$ 60,800	$ 72,850
Investment projection: Keogh Plan to age 65 (23 years); Corporate Plan (to age 65)	$173,800	$1,665,200
Retirement income on a 6% withdrawal plan	$ 10,400 a year	$ 99,900 a year

Blakeslee, *Physicians Profit from Tax Device, Id.* § 1, at 64, cols. 2-3.

According to this analysis, the client, upon incorporation, will save $17,280 per year in taxes, and will retire twenty-three years later on an income of $99,900 per year. While incorporation would increase overhead costs, the client would be able to deduct approximately twenty per cent of gross income to put toward his retirement. In this manner the physician could amass $1,665,200 in investments upon which he could draw as retirement income at age sixty-five. *Id.* at col. 4.

Forty-eight states now permit some form of professional incorporation; New York, Wyoming and the District of Columbia are the sole exceptions. The *Times* noted that "in the last year in Albany, two enabling bills were defeated as legislators argued that professional corporations would serve no other purpose other than to permit doctors to enrich themselves at the expense of the state and Federal Governments." *Id.* at col. 3. It has been noted, however, that a physician "who has half a million or a million dollars in investments waiting for him at retirement is less likely to raise his fees. . . ." *Id.* at col. 4. Incorporation, then, may serve to inhibit the inflationary rise in the cost of medical treatment.

service organizations will enjoy the tax treatment accorded their nonprofessional brethren as long as current law remains unchanged.[65]

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[65] It must be noted, however, that the Treasury Department is presently examining the incorporation trend as part of a broad examination of deferred compensation plans. *Id.* at col. 1. Furthermore, the *Times* has reported that "[t]he agency intends to present legislation in 1970 that would seek to outlaw this practice and to deal with what it considers to be other inequities in the tax treatment of retirement plans for employees and the self-employed." *Id.* at col. 1. *See also* Wall St. Journal, Oct. 27, 1969, at 40, col. 2. Additionally, various proposed changes in the Tax Reform Bill of 1969 will affect the tax benefits available to professional corporations. For instance, section 541 of the Bill, relating to Subchapter S corporations, provides that a shareholder-employee

> must include in his gross income the contributions made by the corporation under a qualified plan on his behalf to the extent the contributions exceed 10 percent of his salary or $2,500, whichever is less. Other employees who are shareholders but own 5 percent or less of the stock in the subchapter S corporation are not subject to this rule, and greater contributions may be made on their behalf without any amount being included in their income.

H.R. 13270, 91st Cong., 1st Sess. § 541 (1969).

The concern of the Department is readily apparent then. As a result, an element of doubt continues to shade the future viability of professional incorporation.