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Article 11

Corporations: Taxation - Professional Corporations - Are They Corporations for Federal Tax Purposes?

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This type of legislation seems to be predicated on the beliefs that some medical treatment in emergencies is better than none at all; and that today's physicians are so conscious of their legal liability in an emergency situation that they "will pass by on the other side" unless they are given absolute assurance beforehand that their wrongful acts, if any, while attending will not later be held against them. It is obvious that the social purpose of Good Samaritan legislation, however, is not to shield the physician from the legal consequences of his wrongful acts. The real beneficiary, if there be one, of Good Samaritan laws is the victim of an accident or other emergency who is helpless and in critical need of immediate medical assistance. And there are doubtless specific instances where no Good Samaritan has acted because he was fearful of the possibility of suit for doing so.[48] Yet one may question the soundness of a law which seeks to further a policy of humanitarianism by releasing a tortfeasor from his obligation to respond in civil damages for his wrongful acts.

J. S. Shannon

PROFESSIONAL CORPORATIONS–ARE THEY CORPORATIONS FOR FEDERAL TAX PURPOSES?

Until recently it was thought that the businessman had many federal tax advantages over the professional man. Since the businessman could form a corporation and obtain certain tax benefits,[1] he had an advantage over the professional man who could not form a corporation. On the surface, however, there seems to have been a drastic change in this picture:

> [Since] the Spring of 1961 a number of state legislatures enacted laws permitting physicians and other professional persons to organize . . . "professional corporations" for the practice of their professions. If classified as "corporations" for federal income tax purposes, these organizations will permit physicians, attorneys, and other professionals to enjoy the federal income tax advantages [of other businesses].[2]

Will state incorporation *per se* entitle these entities to federal corporate tax status? It appears from all available information that the state label will not be the decisive factor.

[48] Kearney, *Why Doctors Are "Bad" Samaritans*, READER'S DIGEST, May, 1963, p. 87.

[1] See Mair, *Professional Corporations and Kintner Associations Advancing: Box Score to Date*, 17 J. TAXATION 2 (1962), see also note 11 *infra*, for listing of tax advantages.

[2] Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1, 1 (1962).

For the purpose of federal taxation, "the term 'corporation' includes associations, joint stock companies, and insurance companies."[3] This broad definition has left the road open for the taxing of certain "associations" as corporations. As early as 1934 the federal courts held that the real test of corporate status, for purposes of taxation, was whether the enterprise more clearly resembles a corporation in its general form and mode of procedure than a partnership.[4] In 1954, following the *Brouillard* decision[5] and subsequent cases,[6] the Court of Appeals in *United States* v. *Kintner*[7] held that an association of doctors was to be taxed as a corporation. In this case the doctors each filed tax returns as employees of the association and therefore did not include in their personal income items deducted as association expenses. The Internal Revenue Service claimed that the association was not a corporation but a partnership since "[t]he laws of Montana do not include the practice of medicine as one of the purposes for which a corporation may be organized."[8] The *Kintner* case[9] resulted in the promulgation of Internal Revenue Regulations 301.7701, establishing criteria upon which professional men could form associations which would be taxed as corporations.[10] These regulations, which were promulgated in 1960, are generally known as the "Kintner Regulations."

The Kintner Regulations at first seemed to be the answer to the professional man's need for legislation to grant him the tax advantages[11] he

[3] INT. REV. CODE OF 1954 § 7701.

[4] Commissioner v. Brouillard, 70 F. 2d 154 (10th Cir. 1934). [5] *Ibid.*

[6] Congress has the power to tax as a corporation an unincorporated association in the form of a trust which transacts its business as if it were incorporated. Morrissey v. Commissioner, 296 U.S. 344, 356 (1935). "[A] trust is an association when (1) it is carrying on a business enterprise for profit, and (2) it has substantial resemblances to a corporation." Pelton v. Commissioner, 82 F.2d 473, 476 (7th Cir. 1936).

[7] United States v. Kintner, 216 F.2d 418 (9th Cir. 1954). [8] *Id.* at 421.

[9] *Supra* note 7.

[10] *Treas. Reg.* § 301.7701-2(a)(1)(1961): "The term 'association' refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) associates, (ii) an objective to carry on a business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."

[11] Tax advantages of incorporation, for the professional man are:

"1. The following items are deductible by corporations for income tax purposes:
   a. Contributions made to qualified pension and profit sharing plans [INT. REV. CODE OF 1954 § 401].
   b. Premiums paid on group life insurance policies [*Treas. Reg.* § 1.264-1 (1961)].
   c. Premiums paid for health, accident, and disability coverage or expenditure

wanted. However, he was still faced with the problem of meeting the criteria established by the Kintner Regulations for obtaining these tax advantages. In addition, the professional man was faced with the problem of receiving the Commissioner's approval of pension plans for professional associations. This occurred when "[t]he Commissioner . . . set up a road block by refusing to grant approval letters to pension plans established by the new groups."[12]

In order to circumvent the problems posed by the Kintner Regulations twenty-two states to date have enacted "Professional Corporations Acts."[13] In considering the reason for these statutes, it was said that ". . . the statutes permitting the organization of professional . . . corporations have no apparent purpose other than federal tax reduction, they alter the non-tax results of professional practice in only minimum degree. . . ."[14] The professional man believed that the label "corporation" would protect him and prevent the Kintner Regulations from applying to him. This belief was based in part on the *unwritten rule* that formal incorporation of an organization under state law will qualify it per se as a corporation for

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made under private plans providing such benefits [INT. REV. CODE OF 1954 § 105 and § 213(a)].

2. The contributions made by corporations for any of the above purposes are not included in their employees' income at the time such contributions of payments are made [INT. REV. CODE OF 1954 § 402].
3. The estate tax exempts death benefits payable under qualified pension and profit sharing plans, if they are payable to named beneficiaries [INT. REV. CODE OF 1954 § 2039(c)].
4. Employees are entitled to sick pay exclusion [INT. REV. CODE OF 1954 § 105].
5. The corporation may provide for a tax free $5,000 death benefit [INT. REV. CODE OF 1954 § 101(b)]." Mair, *Professional Corporations and Kintner Associations Advancing: Box Score to Date,* 17 J. TAXATION 2, 2 (1962).

[12] Haddleton, *Kintner Regulations Now Block Professional Corporations; Final H.R. 10 Rules Analyzed,* February 1964. J. TAXATION 74, 74. (Note: All pension plans must be approved by the Commissioner to be deductible for income tax purposes, and all documents must be submitted by taxpayer—*Treas. Reg.* § 1.404(1961).)

[13] ARIZ. REV. STAT. ch. 10, § 901 (Supp. 1962); Ark. Stat. tit. 64 ch. 20 (Supp. 1963); FLA. STAT. ANN. ch. 621 (Supp. 1961); IDAHO CODE ch. 30, §§ 1401 to 1414 (Supp. 1963); ILL. REV. STAT. ch. 32 §§ 631–647 (1963); BURN'S IND. STAT. tit. 25, § 4901 (Supp. 1963); LAWS OF KY. ch. 236 (1962); ANN. LAWS OF MASS. ch. 156A (Supp. 1963); MICH. STAT. ANN. ch. 450, §§ 221–235 (Supp. 1962); MINN. STAT. ANN. ch. 319 (Supp. 1961); Vernon's ANN. MO. STAT. ch. 356 (Supp. 1963); LAWS OF MONT. ch. 161 (1963); STAT. OF NEV. ch. 385 (1963); N.J. STAT. ANN. ch. 14 tit. 19 (Supp. 1962); N.M. STAT. ch. 51, § 22 (1963); N.D. CENT. CODE ANN., chs. 10–31 (Supp. 1963); OHIO REV. CODE § 1785.02, 1785.08 (Supp. 1961); OKLA. STAT. ANN. ch. 18, §§ 801 to 819 (Supp. 1961); S.D. Laws ch. 29 (1961); LAWS OF UTAH ch. 20 (1963); VT. STAT. ANN. tit. 11, §§ 901–913 (Supp. 1963); WIS. STAT. ANN. ch. 180.99 (Supp. 1961).

[14] Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments,* 17 TAX L. REV. 1, 29 (1962).

federal tax purposes.[15] This rule appears to have ". . . always been accepted as conclusive of federal corporate tax status . . . without a minute inquiry into the presence of corporate characteristics as defined in the Kintner Regulations."[16]

The rule that incorporation under state law is per se corporate status for federal tax purposes was never a part of the Code or Regulations; however, it was given that treatment by the courts. This view was reaffirmed in a recent article wherein it was stated:

> Historically the courts have approached this problem in the same manner; if the enterprise is incorporated under state law as an artificial entity, it is for that reason taxed as a corporation . . . the sole question is whether or not the enterprise has in fact been incorporated.[17]

In the case of *Knoxville Truck Sales and Service, Inc. v. The Commissioner*,[18] the test was whether the taxpayer had a corporate charter from the state or not. For the period of time during which the taxpayer had a charter the Federal Government taxed the business as a corporation. When the corporate charter was revoked, the Federal Government taxed the business as a proprietorship. There was no other change in the business in the years in question.

The result of the passage of the Professional Corporation Acts[19] would appear to be that the professional man will now have the same advantages as the businessman in reference to federal taxation. But there are still questions to be resolved: (1) whether the professional man has really achieved this goal, and (2) if he has, how long will it last.

The first question arises as a result of a conflict between the *unwritten rule* and the opinion of the Commissioner.[20] The *unwritten rule*, as approved by the courts in *Knoxville Truck Sales and Service, Inc. v. The Commissioner*,[21] is that incorporation under state law is per se federal corporate tax status. The holding in that case indicated that state incorporation is a decisive factor in obtaining federal corporate tax status. However, the Commissioner has a different opinion. In an unpublished

[15] 75 HARV. L. REV. 776, 784 (1962); *see also* Anderson, *Tax Aspects of Professional Corporations*, 15 U. So. CAL. 1963 TAX INST. 309; 16 J. TAXATION 238 (1962).

[16] 75 HARV. L. REV. 776, 785 (1962); *see also* Anderson, *Tax Aspects of Professional Corporations*, 15 U. So. CAL. 1963 TAX INST. 309.

[17] Anderson, *Tax Aspects of Professional Corporations*, 15 U. So. CAL. 1963 TAX INST. 309, 320.

[18] 10 T.C. 616 (1948); *see also* Moline Properties, Inc. v. Commissioner 319 U.S. 436 (1943); Burnet v. Commonwealth Improvement. Co., 287 U.S. 415 (1932).

[19] See note 13 for list of states which have passed such corporation acts.

[20] This opinion was stated in an unpublished ruling–see 7 CCH STAND. FED. TAX REP. 6375 (1961).

[21] 10 T.C. 616 (1948).

private ruling he stated that the Internal Revenue Service intends to apply Regulation 301.7701 to determine whether a particular organization shall be taxed as a corporation, in spite of the fact that such organization is labeled "corporation" under state law.[22] Professor Bittker and other legal writers have indicated that the Commissioner's approach is the better one to follow,[23] i.e. the Commissioner and the writers agree that the label "corporation" should not be the decisive factor in determining federal tax status. It seems that this conflict of opinion will have to be resolved by the courts. While the ruling of the Internal Revenue Service may be the determining factor, the existing case law which indicates an opposite approach is still an important factor.[24] If the courts follow the latter, the professional man will have achieved his goal; but if the courts follow the Commissioner's opinion, the Professional Corporation Acts will not be the solution to the professional man's problem of obtaining federal corporate tax status.

However, as a result of recent events, the courts may not have to make this determination. On December 17, 1963, an amendment to Internal Revenue Regulation 301.7701[25] was proposed. The amendment specifically provides that the state label "corporation" will not be decisive.[26] The Kintner Regulations, requiring that several criteria be met before corporate tax status is achieved, would apply to professional organizations irrespective of any state labels. Whether or not the Treasury Department will promulgate this amendment cannot be stated with certainty, but if it does, the effects of the Professional Corporation Acts will be nullified.

[22] 7 CCH STAND. FED. TAX REP. 6375 (1961); *see also* 4 ARIZ. L. REV. 169 (1962).

[23] Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REVIEW 1 (1961); Frost, 4 ARIZ. L. REV. 169 (1962), Anderson, 15 U. So. CAL. 1963 TAX INST. 309.

[24] Knoxville Truck Sales and Service, Inc. v. Commissioner, 10 T.C. 616 (1948); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943).

[25] 7 CCH STAND. FED. TAX REP. 8872-8873 (1964): "(h) . . . The term 'professional service organization,' as used in this paragraph, means an organization formed by one or more persons to engage in a business involving the performance of professional services for a profit which, under local law, may not be organized and operated in the form of an ordinary business corporation having all the usual characteristics of such corporation. Thus, even if a professional service organization is organized as any ordinary business corporation, this paragraph applies if such corporation is subject to local regulatory rules which deprive such corporation of the usual characteristics of an ordinary business corporation. This paragraph applies irrespective of whether an organization is labeled under local law as a professional service corporation, a professional service association, a trust, or otherwise. A professional service organization will be treated as a corporation . . . only if it has sufficient corporate characteristics to be classified as a corporation under paragraph (a) of this section. . . ." [For paragraph (a) see note 10 supra.]

[26] *Ibid.*

In conclusion, it appears that professional corporations will not achieve federal corporate tax status on the basis of state labels alone. Compliance with the Kintner Regulations will be required either if the proposed amendment is promulgated or if the courts overrule the state incorporation theory. From the trend of events of the past three years, as outlined above, it appears that either the Treasury Department or the courts will eliminate the theory that a state corporate label per se gives rise to corporate tax status.

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