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Corporate Employee Tax Status for the Professional Man

*Carmen A. Stavole**

PROFESSIONAL ASSOCIATIONS (*i.e.,* corporations) have been specifically authorized by several state legislatures recently, contrary to the old rule that practice of a learned profession by a corporation is forbidden. Among these states are Connecticut, Illinois, Ohio, Oklahoma, Pennsylvania and Wisconsin. The purpose is to make available to professional men the tax advantages of corporate employee status.

It is important, in reading these statutes, to realize that professional men already can have these tax advantages even in the absence of such state statutes.

Professional persons can realize tax advantages in many cases if they can defer compensation as do corporate officers. Methods of deferring compensation, for example by pension plans, formerly were and now all the more clearly are generally available only to persons having the status of employee.

It is evident that a member of a partnership is not qualified to share in any of these benefits since he is not considered to be an employee within the meaning of the Internal Revenue Code. However, a person who is employed by a corporation is an employee irrespective of the fact that he may own 100 percent of the outstanding stock. As a result of this employee status he is allowed to participate in any deferred compensation plan which is found to be qualified under the applicable provisions of the Internal Revenue Code.

There are numerous tax advantages available to employee-shareholders of a corporation. Probably the most publicized are:

1) Earnings taxed to shareholders in year of distribution
2) Deferral of compensation via stock options
3) Other tax free benefits available to employees
   a) Accident and Health Insurance[1]
   b) Sick pay plans[2]
   c) Group life insurance[3]

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1 Sec. 106, I. R. C. (1954).

2 Sec. 105(d).

3 Income Tax regulations 1.61-2(d) (2).

The professional man who would like to share in these advantages in most states still is confronted with state statutes limiting the privilege of incorporating. The long established no-corporate-practice statute of Ohio, typical of most, sets forth the rule that a corporation may be formed for any purposes, other than for carrying on the practice of a learned profession.[4] In the past, the doctor, dentist, lawyer, engineer and accountant examined the statutes and saw all hope for corporate tax benefits fade before his eyes.

Then on to the scene came a group of doctors who saw in Section 39.3797-1 of Income Tax Regulations 118 a flicker of light. This section states,

> For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. *Local law is of no importance* (italics supplied) in this connection . . . The term 'corporation' is not limited to the artificial entity usually known as a corporation, but includes also an association.

Section 39.3797-4[5] stated in effect that the real nature of the organization must be considered. If clothed with the ordinary functions and attributes of a corporation, it is subject to appropriate treatment. It follows that if an association is treated as a corporation it will receive all the tax advantages as well as the disadvantages of a corporate body.

In the *Morrissey* decision in 1935 the U. S. Supreme Court laid down the following tests of a corporation:

1) Ownership by the entity of property embarked in the undertaking,
2) Centralization of management through representatives of members,
3) Control of management through selection of managers by members,
4) Continuity of enterprise without interruption by death of a member or transfer of membership,
5) Limitation of personal liability of members to the property embarked in the undertaking.[6]

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4 Ohio Rev. Code Sec. 1701.03. For a complete discussion see 1 Oleck, Modern Corporation Law, c. 4 (1958).

5 Sec. 39.3797-4, Reg. 118 Partnerships. ". . . the code classifies under the term 'corporation' an association or joint-stock company, the members of which may be subject to the personal liability of partners. 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 representative capacities, such an organization is an association, taxable as a corporation."

6 Morrissey v. Commissioner, 296 U. S. 344, 80 L. Ed. 263 (1935).

The *Pelton* decision,[7] and Section 3797 (a) (3) of the Internal Revenue Code of 1939[8] both strengthened the position of an association claiming corporate tax benefits.

Armed with these regulations and case law, a group of doctors practicing as a partnership dissolved their partnership and executed articles of association under the name of Western Montana Clinic association. The association created a pension plan under what is now section 401(a) of the 1954 Code. The doctors' time was controlled by the association; they reserved none of the fees earned as such, and they had no readily transferable interest in the association. A member could be discharged from membership in and employment by the association, and the association still continue in business. Office hours and vacations of the doctors were set by the association. The affairs of the association were conducted by a committee acting in a representative capacity.[9]

From these facts it can be seen that the doctors did not comply with all the tests laid down by the *Morrissey* decision. There was no limitation of personal liability nor transferability of beneficial interests. Nevertheless the court found that the association was a corporation for income tax purposes and that the reserve funds set aside by the association were not taxable to the doctors since the funds had not been distributed. The principles decided in this case have come to be known as the *Kintner* doctrine.

The *Kintner* decision found that something less than the five tests laid down by the *Morrissey* decision was sufficient to establish an association taxable as a corporation.

Subsequent to the *Kintner* decision the Commissioner of Internal Revenue in Revenue Ruling 56-23 issued his non-acquiescence.[10] The effect of a non-acquiescence is that a court decision, other than a Supreme Court decision, will not be considered to be a controlling factor and that it will not be accepted by

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[7] Pelton vs. Commissioner, 82 F. 2d 473 (7th Cir. 1936). A medical and surgical clinic which was set up as a trust was held to be an association where it was shown that the trust had a substantial resemblance to a corporation and was carrying-on business for a profit.

[8] Now Sec. 7701(a) (3) which states "The term 'corporation' includes associations . . . ."

[9] United States v. Kintner et ux., 216 F. 2d 418 (9th Cir. 1954).

[10] Rev. Rul. 56-23, CB 1956-1, p. 598. "A group of doctors who adopt the form of an association to obtain the benefits of corporate status for purposes of section 401(a) of the Internal Revenue Code of 1954 is in substance a partnership and the doctor-members are employers and therefore not employees."

the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations. It is clear that a taxpayer must litigate his position when he bases his case on a non-acquiesced court decision, or he will not succeed.

A later ruling[11] modified the position taken in Revenue Ruling 56-23 and further stated,

> The basic criteria to be used in testing as to such organizations the existence of an association taxable as a corporation will be stated in a Revenue Ruling to be published at a later date.

In 1959 in the case of *Galt v. U. S.*, a District Court in Texas came to a similar conclusion on facts closely resembling those of the *Kintner* case. The Texas court interpreted a medical association to be a corporation within the purview of Section 7701(a) (3) of the 1954 Internal Revenue Code. The syllabus of that case provides:

> Corporate, not partnership status, attributed to association of doctors organized to operate a clinic and practice medicine. Under local law a corporation could not be found to do these things. But the articles of association were so drawn as to include in substance all those things that would have been written into a corporate charter had it been possible to form a corporation.[12]

Although the *Kintner* and *Galt* decisions dealt with medical doctors, the principles established therein would apply to other learned professions which are normally barred from incorporating by state statutes.

It should be borne in mind that the *Kintner* decision was based on an interpretation of Section 3797 of the 1939 Internal Revenue Code and applicable regulations. The wording in this section is identical with Section 7701(a) (3) of the 1954 Code which is presently in effect. The income tax regulations on Section 7701 were promulgated on November 15, 1960, a period of six years having elapsed since the enactment of the applicable code section.

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[11] Rev. Rul. 57-546, CB 1957-2, p. 886. "It is now the position of the Service that the fact that an association establishes a pension plan under section 401(a) of the Internal Revenue Code of 1954 is not determinative of whether such organization will be classified as a partnership or an association taxable as a corporation. The usual tests will be applied in determining whether a particular organization of doctors or other professional groups has more of the characteristics of a corporation than of a partnership."

[12] Sidney Galt and Wife Duffy Galt v. U. S., 4 A. F. T. R. 2d 52271, 175 F. Supp. 360 (DC Tex. 1959).

It was originally thought that since the 1954 Code did not make any change in the law with respect to the taxability of trusts, partnerships, associations, and other organizations as corporations[13] that the regulations would be similar to those issued under the 1939 Code. However, the new regulations are much more comprehensive because of the case-made law on the subject. Whereas the former regulations provided,

> Local law is of no importance,

the present regulations provide,

> Although it is the Internal Revenue Code rather than local law which establishes the tests or standards 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 relationship of the members of the organization among themselves and with the public at large . . .[14]

The regulations further provide,

> An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics.[15]

The major characteristics of corporate form are generally found to be: (1) an entity consisting of associates, (2) an objective to carry on business and divide the gains, (3) continuity of life, (4) centralization of management, (5) limited liability, (6) free transferability of interests. Without further investigation into the regulations, it would appear simple enough to form an organization having a majority of the characteristics. However,

> In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered.[16]

It is apparent that by a process of elimination there now remain only four of the original six major characteristics, since a partnership also has associates and an objective to carry on business

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[13] Sec. 6501(g)(1) and Mertens, Law of Federal Income Taxation, Sec. 38A.01.

[14] Reg. 301.7701-1(c).

[15] Reg. 301.7701-2(a)(3).

[16] *Ibid.*

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and divide the gains therefrom. To qualify as an association one must therefore satisfy a majority of the remaining four characteristics:

(1) Continuity of existence
(2) Centralization of management
(3) Limited liability
(4) Free transferability of interests.

The regulations then go on to discuss agreements entered into to meet the requirement of continuity of existence.

> Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a state statute corresponding to either the Uniform Partnership Act or the Limited Partnership Act would lack continuity of life.[17]

As to the remaining requirements, namely, centralization of management, limited liability, and free transferability of interests, the regulations provide in effect that if the state has a statute which corresponds to the Uniform Partnership Act or the Limited Partnership Act any attempt by such a partnership to comply with the characteristics of a corporation would be specious since it would be contrary to the provisions of the local law, and,

> 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.[18]

It should be borne in mind that not all states have adopted all the provisions of the Uniform Partnership Act. In those states which have not adopted the provisions the written agreement between the parties will not be disturbed by the effect of local law as applied in the regulations.

It is evident that the regulations now require a study of state law to determine whether provisions have been adopted similar to the Uniform Partnership Act with regard to continuity of life, centralization of management, limited liability and free transferability of interests. In addition some states may have made provisions for partnership associations which do not come within the purview of the Act.

As we have mentioned earlier, an organization treated as a corporation receives all the tax disadvantages along with the advantages. Some of the more striking disadvantages are:

[17] Reg. 301.7701-2(b)(3).
[18] Reg. 301.7701-1(c).

1) Double taxation—earnings taxed to the corporation and also taxed to the shareholders when distributed,
2) Surtax on personal holding companies,[19]
3) Accumulated earnings tax.[20]

The accumulated earnings tax was designed to force corporations to distribute their earnings to shareholders and thus to control to a limited extent the attempt to level income (i.e., determining the most advantageous time to distribute earnings).

Personal Holding Company

Probably the most devastating pitfall that could entrap a corporation is for it to be treated as a personal holding company, whereby its surtax may be as high as 85 percent of the personal holding company profits.

Inasmuch as this danger is extremely serious, it is apropos that we discuss, at least to a limited extent, the susceptibility of a *Kintner* association to being classed as a personal holding company if precautions are not taken. If one is aware of the dangers he will take immediate measures to eliminate their causes rather than await an examination by a Revenue Agent and then find it necessary to remedy their effects.

In any established profession there is generally a personal relationship between the practitioner and his clients or patients, as the case may be. Therefore, when one of these associations taxable as a corporation is formed, a doctor or lawyer may find that his former patients or clients may insist that he personally treat his illness or handle his problem. It is in this situation that the possibility exists for the association to be classed as a personal holding company.[21] If at least 80 percent of its gross income is from personal service contracts as defined in section 543,[22] and if 50 percent in value of its outstanding stock is owned,

[19] Sec. 541.

[20] Sec. 531.

[21] Sec. 542. Definition of Personal Holding Company.

[22] Sec. 543(5). Personal Service Contracts.
A. Amounts received under a contract *which the corporation is to furnish personal services*; if some person other than the corporation has the right to designate (by name or description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or description) in the contract; and
B. Amounts received from the sale or other disposition of such a contract. This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable

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directly or indirectly,[23] by or for not more than five individuals,[24] a personal holding company exists.

It follows that in order to avoid the personal holding company tax the personal relationship must be removed by putting the power to dictate which doctor or which lawyer will perform the service in the hands of the association.

The possibility of being exposed to the hazards of the personal holding company tax will dissuade some professional persons who may feel unable to avoid its dangers, whereas others, with proper planning, will successfully avoid the dangers.

Subchapter S

With the advent of Subchapter S to the 1954 Code[25] the possibility of a most fascinating abnormality came into existence: the possibility of a group of professional men banding together in an association, having the characteristics of a corporation under the *Kintner* doctrine, and electing under the provisions of Subchapter S to be taxed as a partnership.[26] Thus these persons find themselves back in a partnership status for tax purposes and at the same time they have achieved what they set out to do. They will be deducting from current earnings of the association all those special employee plans for which they could receive no tax free status as a partner. Also they need not fear those striking disadvantages which are peculiar to a corporation such as double taxation, surtax on personal holding companies, and accumulated earnings tax. These disadvantages are avoided because the association elects to be taxed as a partnership, and the net earnings are taxed to the individual members irrespective of the fact that they may not be distributed.

Thus, through the application of the *Kintner* doctrine and Subchapter S, we have a "partnership" doing indirectly what it could not do directly. However, it is reported that the Treasury

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year 25 percent or more in value of the outstanding stock of the corporation is owned directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform such services.

[23] Note. For a discussion of stock attributions see 3 Oleck, Modern Corporation Law, Par. 1191-1202 (1959).

[24] Sec. 542(a)(2). Stock Ownership Requirement.

[25] Technical Amendments Act, Public Law 85-866, Sec. 64 (1958). This section allows a corporation to be taxed as a partnership.

[26] Stutsman, How to Organize Professional Men for Corporate Tax Status Under Kintner, 11 J. of Taxation 336. Also see Reg. 1.1371-1(b).

intends to urge Congress to amend the Code to deny to corporations that have made an election under Subchapter S the right to have a qualified pension or profit-sharing plan.[27] There has been no amendment to date.

In order to be eligible to make an election under Subchapter S, a corporation must qualify as a small business corporation. It must meet four requirements, one of which is that it may not have more than 10 shareholders.[28] The question may arise that since the section defining a Subchapter S corporation speaks of shareholders, what happens to those associations in which there are no shareholders within the literal meaning of that word? Will that rule them ineligible? The answer lies within the Internal Revenue Code itself.

> The 'term' shareholder includes a member in an association, joint-stock company, . . .[29]

The regulations set down the requirement that in order to be considered as a small business corporation a corporation must have only one class of stock.[30] Many regard this requirement, as far as Kintner associations are concerned, as a necessity to have an issue of stock.[31] Since the stock is not such that would be issued for sale on the open market it does not appear that much difficulty will be encountered in attempting to register with the State Securities Division solely to obtain federal tax benefits. The purpose of requiring stocks to be registered or qualified under the Securities Act is to enable the Securities Division to obtain sufficient information about the stock to enable the Division to prevent frauds and to establish whether or not the issue is safe for investors.[32]

It is not intended to discuss all the various ramifications of Subchapter S, but only to clarify those points which appear to conflict with the eligibility of a *Kintner*-type association to elect to be taxed as a small business corporation.

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27 11 J. of Taxation 278.

28 Sec. 1371. Also see Greenwald, Tax Subchapter S Becomes Clearer, 9 Clev.-Mar. L. R. 566 (1960).

29 Sec. 7701(a) (8).

30 Reg. 1.1371-1(g).

31 *Supra,* note 26.

32 Hall v. Geiger Jones Co., 242 U. S. 539, 61 LE 480 (1916), Groby v. State, 109 O. S. 543, 143 N. E. 127 (1924); Ohio Rev. Code 1707.08; Sellers v. State, 18 O. L. Abs. 328 (Ohio Ct. App., 6th Dist. 1934); Edward v. Ioor, 205 Mich. 617, 172 N. W. 620 (1919); Kneeland v. Emerton, 280 Mass. 371, 183 N. E. 155 (1932).

Conclusion

Through interpretations of various code sections cited herein it has been shown that associations which looked and acted like corporations were given corporate tax status. Once the status was obtained the members subsequently received all the income tax benefits of a corporation. It was further shown that although there are numerous advantages to these *Kintner*-type associations as they are called, there are a corresponding number of disadvantages and only proper planning can alleviate the latter. Finally it was demonstrated that with the addition of Subchapter S to the Internal Revenue Code, it appears to be possible to obtain all the advantages of a corporation while the income continues to be taxed to the members.

In conclusion it should be made clear that the objective of this article was not to lay forth a format for the mechanics of organizing a *Kintner*-type association, but merely to illustrate that it is possible at the present time for the professional man to receive corporate tax treatment while still operating within the old no-corporate-practice state statutes, regardless of whether or not professional association incorporation is provided for in his state.

These facts should have a pronounced effect in the interpretation of the new "professional associations (corporations)" statutes. They strongly suggest that corporate employee tax status already was available to professional men even before the enactment of the new state statutes.