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SOME COMMENTS AS TO PROFESSIONAL CORPORATION STATUTES

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Introduction

Because of a long-standing inequity in the federal income tax law[1] [which the author believes still exists despite the recent enactment of the Self-Employed Individuals Tax Retirement Act of 1962 (H.R. 10)[2]], the bar in many states has found mounting pressure to re-examine the organization of law offices to determine whether the prohibition against corporate practice is an important principle in safeguarding the high ethical standards of the profession or is merely an historical fact of no real significance.

It is believed fair to say that the majority of the bar, particularly those who have been in practice for a number of years, recoil at first from the thought of a professional law corporation. Yet it has been the author's experience that many recognized leaders of the bar who initially had such a reaction, once they have had an opportunity to thoroughly study the issues, have become some of the strongest advocates of legislation to allow professional corporations. I think the reasons for this are as follows:

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* See Contributors' Section, p. 254, for biographical data.

[1] Such inequity has been recognized by committees of both the Senate and House of Representatives. See, *e. g.*, S. REP. No. 1615, 86th Cong., 2d Sess. 4 (1960), and H.R. No. 64, 86th Cong., 1st Sess. 2 (1959).

[2] Because, for example, of (a) the strict limitations on the deductibility of contributions, (b) the elimination of capital gain treatment on lump sum distributions. (c) the elimination of the possible estate tax exemption, (d) as to owners of more than a 10% capital or profits interest in the business, the much stricter requirements for coverage of employees who are not owners, and (e) the effect of requiring all self-employed persons coming under the act to consider both the deductible and nondeductible contributions by them in determining what corresponding nondiscriminatory contributions must be made on behalf of employees who are not owners.

First: The differences between present practice and incorporated law offices are more theoretical than real. Medium- and large-size law offices today have many of the same characteristics as the proposed professional corporations. For example, they have (i) lawyers who are employees, (ii) lawyer-employees who are immune from liability for the tortious or contractual acts of the other lawyers in the firm, (iii) centralized management through the partners or a group of partners in which the lawyer-employee has little or no voice, and (iv) continuity of existence beyond the death of one of the partners. In addition, mechanics are often worked out to provide for an orderly transfer of partnership interests upon the death or retirement of an existing partner. It is true that each of the partners has personal liability for the contractual and tort liability of the others, but as will be mentioned later, this again is more of a theoretical than real difference because of malpractice and other liability insurance.

Second: the interposition of a legal fiction, the corporate entity, between the partners and their clients need not make any difference in substance as to the attorney-client relationship. Certainly the attorney performing the services is going to continue to have the same moral and legal obligations and responsibilities as before, and clients will continue to look to the particular lawyer handling their affairs to the extent they have done so in the past. It is true that if the professional corporation is to be given limited liability, then a client could no longer regard the personal assets of all of the partners as standing behind the malfeasance of the lawyer performing his work, but it is doubtful that clients either choose or continue retaining a law office because of the personal net worth of the partners. They do not choose a lawyer because he is independently wealthy or has wealthy partners, but rather because he is able. They do not choose a partnership rather than a sole proprietorship because of the greater aggregate net worth. Nothing is probably further from the client's mind than the fact that his choice of lawyer might engage in malpractice. In this connection, it is interesting to note that the concept of unlimited personal liability between partners of a law firm derives from partnership law, not the attorney-client relationship.[3] It was not so long ago that lawyers could not practice except as sole proprietors — and it is understood that this is still true today as to barristers in England. Further, even under a professional corpora-

[3] See Report of the Committee on Incorporation of Law Offices, State Bar of California (Jan. 15, 1962). See the summary of such report in 37 CALIF. STATE B.J. 473 (July-Aug. 1962).

tion statute providing for strict limited liability, the attorney performing the work and the professional corporation would always be responsible to the client for the attorney's malfeasance under general principles of tort and agency law.

ABA Opinion 303

A giant step forward toward the use of professional law corporations was taken when Opinion 303 was adopted and published by the Professional Ethics Committee of the American Bar Association.[4] Under this Opinion, the committee held that lawyers can carry on the practice of law as a professional association or professional corporation which has the characteristics of limited liability, centralized management, continuity of life, and transferability of interest without being in violation of one or more of the Canons of Ethics, provided appropriate safeguards are observed. In other words, a professional corporation may, but does not necessarily, violate any of the Canons of Ethics.

It should be noted that the committee carefully refrained from expressing any judgment on the following matters: (a) whether any particular professional association or professional corporation will be classified as a corporation for federal income tax purposes (noting in passing that there may be some doubt whether the various statutes enacted in 1961 will achieve such result), (b) what federal income tax advantages will be available to a group of lawyers if the form of organization adopted by them for the practice of law is treated as a corporation for federal income tax purposes, or (c) the wisdom or feasibility of lawyers adopting, as a form of organization for the practice of law, the professional association or professional corporation. Opinion 303 adds, moreover, that upon the latter subject the members of the committee "have grave doubts."

Without summarizing the entire analysis of the problem in Opinion 303, it is believed worthwhile to mention comments made in the Opinion on the subject of limited liability. It mentions that Canon 35 states a lawyer's relation to his client should be personal, and the responsibility should be direct to the client. The close lawyer-client

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[4] *ABA Committee on Professional Ethics, Opinion 303,* 48 A.B.A.J. 159 (Feb. 1962); ABA Section, Taxation Bulletin 17 (Jan. 1962). Also note Report of the Special Committee to Cooperate with ABA Committee on Professional Ethics re Association of Attorneys Taxable as Corporations (July 17, 1961), and Report of the Committee on Pension and Profit-Sharing Trusts, ABA Section of Real Property, Probate and Trust Law (July 1, 1962).

relationship which Canon 35 was designed to foster cannot be attained unless the client's reasonable expectations as to the scope of the responsibility for the legal services being rendered is a reality. Canon 33 provides that in the selection and use of a firm name, no false, misleading, assumed, or trade name should be used. The name under which a group of lawyers practices would be misleading if it failed to reveal any restrictions on the responsibility of the individual lawyers for the legal services rendered. If the professional association or professional corporation is organized to practice law and the lawyers other than the ones rendering the legal services to a client are not under any personal liability therefor, the fees collected for the legal work will nevertheless go to the association or corporation and in due course will be shared by all the lawyers in the organization. Canon 34 permits a division of legal fees for legal services with another lawyer if the division is based upon a division of service or responsibility. All lawyers within an organization bear a professional responsibility for the legal services of the organization, whether they are under any personal legal liability for all of such services or not. This general professional responsibility of all, though legal liability is limited, prevents any violation of Canon 34 when the lawyers in the organization are entitled to share in the fees collected without regard to whether they personally participated in the rendition of the legal services. The opinion then concludes that these comments:

> make it clear that it is possible for lawyers to engage in the practice of law under a form of organization that imposes limited liability without violating any of the Canons of Ethics if the following safeguards are observed:
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> 1. The lawyer or lawyers rendering the legal services to the client must be personally responsible to the client.
> 2. Restrictions on liability as to other lawyers in the organization must be made apparent to the client.

The author has one major quarrel with Opinion 303. In the body of the Opinion, it calls attention to Canon 34, which prohibits any division of fees for legal services with a nonlawyer. The Opinion recognizes, of course, that practicing lawyers may employ many nonlawyers and that the source of funds to pay them for services will be fees for legal services rendered. It states that the use of the fees to pay agreed salaries to nonlawyer employees is not a violation of Canon 34. However, if the salary of a nonlawyer employee is to be based on a percentage of the net profits, a division of fees for legal services would be involved and Canon 34 would prohibit it. Opinion 303 then states:

> Thus if a professional association or professional corporation is organized to practice law and it is approved as a corporation for federal income tax purposes, it would not be ethically proper for it to have a profit sharing plan if non-lawyers were included as beneficiaries of the plan.

It seems clear that a currently distributable profit-sharing plan for lay personnel would violate Canon 34. However, in the author's opinion, a qualified profit-sharing retirement plan is an entirely different matter. In such a plan, although it is contingent upon profits, the contributions are merely a method of funding a retirement plan, the proceeds of which are distributable only upon retirement, death or earlier termination of service. Assuming a law partnership has a history of making a certain level of profits and then adopts a profit-sharing retirement plan, the contributions to which are well within its historic level of profits, it would seem that the inclusion of lay personnel in such a profit-sharing retirement plan would no more be a violation of Canon 34 than would be the payment of fixed salary or fixed bonus payments out of an expected level of fees.[5]

Action of State Courts

It is interesting to note that the Supreme Court of Colorado, on December 5, 1961, adopted State Bar Rule 231, permitting lawyers to practice in corporate form without the usual enabling legislatiton. It is understood that the Federal District Court located in Colorado and the Court of Appeals for the Tenth Circuit have indicated acceptance for practice of lawyers employed by a Colorado professional corporation.

In *Matter of the Florida Bar*,[6] the Florida Supreme Court approved a change in The Integration Rule of the Florida Bar and The Code of Ethics to permit lawyers to incorporate under the Florida Professional Service Corporations Act.

In Oklahoma a petition to the Oklahoma Supreme Court referred to the Florida developments.[7] The Oklahoma Supreme Court by pronouncement[8] stated that "members of the Oklahoma Bar may, at their option, incorporate the business aspects of their practice," and further stated: "In view of the continuing inherent power and jurisdiction over the subject matter by this Court, as well as the provisions

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[5] It is interesting to note that a similar problem might be raised under the Self-Employed Individuals Tax Retirement Act of 1962 unless a straight pension plan is used for coverage of lay personnel.

[6] 133 So. 2d 554 (Fla. 1961).

[7] Application of Executive Council of the Oklahoma Bar Association, in the Matter of the Oklahoma Professional Corporation Act, p. 4.

[8] Supreme Court Bar Docket of Oklahoma, No. 1878, Dec. 29, 1961.

of section 13 of the Act, this Court retains jurisdiction to make such further rules, regulations and pronouncements as may be necessary."

On the other hand, the Ohio Supreme Court in *State ex rel. Green v. Brown*,[9] held that mandamus did not lie to the Secretary of State to compel him to accept for filing articles of incorporation on behalf of a group of lawyers. The State Bar Association of Ohio intervened in this test case, urging that mandamus be denied. The court held that the act was ineffective to authorize the corporate practice of law; that authorization must flow from the court in its capacity to prescribe professional standards for attorneys. In October 1961 the State Bar Association of Ohio requested lawyers to defer filing articles of incorporation pending further study by the State Bar Committee.

States That Have Adopted Professional Corporation or Association Statutes

It is understood that all of the recent activity in the area of professional corporation and association legislation resulted in new legislation or legal interpretations in 14 states in 1961 and in six states in 1962. Bills have been introduced but died or were vetoed or are still pending in 11 other states. An excellent analysis of all of this legislation can be found in the Report of the Committee on Pension and Profit-Sharing Trusts of the American Bar Association, Section of Real Property, Probate and Trust Law, dated July 1, 1962. Some of these new statutes have authorized professional corporations, others have authorized professional associations.

In this Report, the action of the State of Arizona in adopting a Professional Corporation Act[10] is described as follows:

1. Legislation: Professional Corporations Act, enacted March 20, 1962, and effective on that date. Description:

A. Professional corporations may be formed by two or more individuals licensed to practice the same profession.

B. Organized for a stated number of years not to exceed twenty-five. At the end of the period, the duration may be extended under the Act.

C. May render professional service through shareholders, directors, officers, agents and employees.

D. Corporation name must end with the designation 'Professional Corporation,' 'P. C.,' 'Limited,' 'Ltd.,' 'Professional Association,' 'P. A.,' or 'Chartered.'

E. Shares transferable to other individuals licensed to practice the same profession or to corporation itself.

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[9] 173 Ohio St. 114, 180 N.E.2d 157 (1962).

[10] ARIZ. REV. STAT. ANN. §§ 10-901-09 (Supp. 1962).

F. Activities limited to those which a licensed individual can perform.
G. Joint and several liability on part of shareholders.
2. No report of other bills introduced.
No other activity reported.

Why Are Professional Corporation or Association Statutes Necessary?

A brief history of the pertinent section of the Internal Revenue Code and applicable Regulations is helpful in bringing this problem into focus. Chapter 79 of the Internal Revenue Code contains numerous definitions, including the following definition of the term "corporation": "CORPORATION — The term 'corporation' includes associations, joint stock companies and insurance companies."[11]

The Regulations promulgated under section 7701(a)(3) include a number of requirements with respect to "associations" if they are to be taxed as corporations. Under such Regulations, if an association is to be taxed as a corporation, it must have more corporate than noncorporate characteristics. The principal corporate characteristics pertinent to this discussion set forth in such Regulations are as follows:

1. Continuity of life;
2. Centralization of management;
3. Liability for corporate debts limited to corporate property; and
4. Free transferability of interests.

For purposes of this discussion, we will assume that these Regulations are valid. It should be kept in mind, however, that there is considerable dispute on this subject.[12] Further, my discussion will be limited to an analysis of the law in states where the Uniform Partnership Act is in effect.

First of all, it should be noted that it appears the Uniform Partnership Act would control whether the organization is called an association or partnership.

Because the Uniform Partnership Act imposes personal liability on each general partner as to the obligations of the partnership, it seems clear that such an association or partnership could not meet the limited liability test of the Regulations. It also appears that the

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[11] INT. REV. CODE of 1954 § 7701 (a) (3). It should be noted that the words "associations, joint stock companies and insurance companies" are given as examples of those organizations included within the term "corporation," and that the definition does not purport to define what organizations entitled "corporations" are not to be treated as such for federal income tax purposes.

[12] See, *e.g.*, Wolfman & Price, *Qualifying Under Final Kintner Rules Will Be Difficult in Most States*, 14 J. TAXATION 105 (1961).

Uniform Partnership Act prevents such an organization from having centralized management. Although it is believed that two of the required corporate attributes, (a) continuity of life[13] and (b) a modified form of free transferability of interests, could be obtained under the Uniform Partnership Act, the conclusion appears inevitable that such an association or partnership would not have sufficient corporate characteristics to qualify to be taxed as a corporation under the Treasury Regulations. Thus, additional legislation, either state or federal, would be required to enable a law partnership or association to qualify as a corporation for tax purposes under the Regulations.

In some states it might be possible to use the Massachusetts trust form of organization in order to accomplish the desired result. In California this approach was discarded because, among other reasons, the Massachusetts trust form of doing business is unavailable to sole proprietors. Further, attention should be given in this regard to Opinion 283 of the Committee on Professional Ethics of the American Bar Association, which holds that it would not be permissible under the Canons of Ethics to set up within any law firm a common law or Massachusetts trust type of arrangement for practice by lawyers. This opinion is referred to and distinguished in Opinion 303.

Attitude of the Internal Revenue Service

It might be thought that such Regulations would not be applied by the Internal Revenue Service to a professional corporation since IRC § 7701(a)(3) (under which such Regulations were promulgated) only defines organizations included within the term "corporations" and does not purport to define organizations entitled "corporations" under state law, which are not to be treated as such for federal income tax purposes.

However, the Internal Revenue Service has indicated in a recent private ruling[14] involving a nonstock corporation under the Connecticut law that it intends to apply the Regulations promulgated under IRC § 7701(a)(3) to determine whether a particular organization shall be taxed as a corporation even though such organization is labeled as a corporation under applicable state law. In other words, the Internal Revenue Service may seek to go beyond the classification given to the organization under state law.

This makes a particularly difficult problem for sole proprietors desiring to come under a professional corporation statute, since by definition the proprietor does not have "associates" or centralized man-

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[13] At least as the Uniform Partnership Act is in effect in California. See CAL. CORP. CODE § 15031.

[14] Special Ruling (unpublished), C.C.H. 1961 STAND. FED. TAX REP. § 6375.

agement. But historic requirements of corporate status have not depended on the number of owners. Solely owned corporations are nonetheless "pure" corporations under the California law. (The term "pure" is borrowed from Treasury Regulations § 301.7701-2 and is interpreted to mean an organization formed as a corporation under the traditional state corporation law and having the historic legal relationships of a corporation under such law in form and substance.) Even though a minimum of three incorporators and three directors is required, the California general corporation law does not require that there be more than one stockholder-owner.

Although a number of rulings were issued under the old Regulations which were effective for taxable years beginning prior to January 1, 1961, so far as I know, only two rulings have been issued by the Internal Revenue Service under the new Regulations. (One is the Connecticut nonstock corporation ruling mentioned above and the second relates to a nonprofit association.) For this reason there is a substantial backlog of ruling applications on file with the National Office as to which some disposition must soon be made. The problem that appears to be bothering the Internal Revenue Service is the fact that their own Regulations require regard for local state law, such as the Uniform Partnership Act, in determining the legal relationships between the parties. Since a number of states have changed the local law and thus changed such relationships, the Service is faced with the dilemma of whether to be consistent in applying state law and thus give favorable rulings, or whether to be inconsistent or withdraw from its prior position as to the importance of state law, and in such event, perhaps require conformity with a national or federal rule for corporate status.

In any event, there has been considerable speculation (particularly since Professor Bittker's article, mentioned later) that the Internal Revenue Service may take a negative, if not hostile, attitude towards ruling applications under the professional association and corporation statutes, and therefore will not clarify the law in this regard except as to factual situations where the requirements of the present Regulations are met. If this position is taken by the Internal Revenue Service, then the rationale must be based on one or more of the following theories:

(1) That the particular professional corporation is not a "pure" corporation under the general corporate law of its state, but rather is a special or hybrid corporation, and therefore the corporate entity should be disregarded for federal income tax purposes unless the organization meets the requirements of the Regulations; or

(2) That the particular professional corporation, although a "pure" corporation, is not the same in substance as a general business corpo-

ration under the law of its state (because, for example, it is subject to stringent control and supervision not generally applicable to business corporations), and therefore can be separately categorized for federal income tax purposes; or

(3) That even though the particular professional corporation is a "pure" corporation, and cannot fairly be distinguished from a general business corporation for all practical purposes relevant to corporate status, its employees are not entitled to receive the benefits of Subchapter D (IRC § 401 et seq.) because of some unknown policy determination by the Internal Revenue Service.

It is believed that only the first of these alternatives might be persuasive with the courts, and in all cases its application should be strictly limited by the courts to factual situations where the organization in substance is not a traditional corporation under applicable state law.

Assuming that the particular professional corporation is in fact a "pure" corporation under the applicable state law, it is believed that there is no justification for distinguishing as to corporate status between a corporation performing professional services and an ordinary business corporation, even though the former is subject to more control and supervision than may generally be the case for ordinary business corporations. For example, a stricter degree of supervision and control is also true as to banking corporations, industrial loan companies, and the like. This does not mean that such organizations are any the less corporations in the historic sense.

Commentaries on Existing Statutes[15]

Undoubtedly the most controversial article in this area is that

[15] For articles other than those discussed herein, see:
Alexander, *Some Tax Problems of a Professional Association*, 13 W. RES. L. REV. 212 (1962).
Blake, *Professional Association Laws and the CPA*, 113 J. ACCOUNTANCY 37 (1962).
Eber, *The Pros and Cons of the New Professional Service Corporation*, 15 J. TAXATION 308 (1961).
Jones, *Should Lawyers Incorporate?*, 11 HASTINGS L.J. 150 (1959).
Jones, *The Professional Corporation*, 27 FORDHAM L. REV. 353 (1958).
Lyon, *Action in Indiana on Kintner-Type Organizations*, 39 TAXES 266 (1961).
Maier, *Don't Confuse Kintner-Type Associations with Professional Corporations*, 15 J. TAXATION 248 (1961).
Maier, *Professional Corporations and Kintner Associations Advancing; Box Score to Date*, 17 J. TAXATION 2 (1962).
Ray, *Corporate Tax Treatment of Medical Clinics Organized as Associations*, 39 TAXES 73 (1961).
Silberman, *Doctors, Inc.; Professional Men Push for Incorporation, Aim at Income Tax Savings*, 66 Wall St. J. No. 101, May 23, 1962, P.1.
Thrower & Cohen, *Professional Associations Under the Georgia Act — Some Tax Aspects and Considerations of Legal Ethics*, 24 GA. B.J. 163 (1961).
Vesely, *The Ohio Professional Association Law*, 13 W. RES. L. REV. 195 (1962).

written by Professor Boris Bittker of the Yale Law School, entitled "Professional Associations and Federal Income Taxation: Some Questions and Comments."[16] In this article Mr. Bittker comes to the general conclusion that organizations qualifying under either the existing state professional association statutes or the existing state professional corporation statutes should not be treated as corporations for federal income tax purposes. In arriving at this conclusion Mr. Bittker first analyzes several of the professional association statutes that have been recently enacted by various states. He picks as his first and major victim in this area the statute of the State of Georgia. He then compares provisions of this statute with the requirements of the Regulations promulgated under Internal Revenue Code § 7701(a)(3) mentioned above. In applying the tests of these Regulations to the Georgia Professional Association Act, Mr. Bittker arrives at the conclusion that it is doubtful whether an association created thereunder has limited liability, continuity of life, or free transferability of interests, although he concedes that it would have centralized management in a modified form. Thus he states that such an association is not a corporation for federal income tax purposes.

Mr. Bittker then goes on to analyze the professional association statutes of the States of Connecticut, Illinois, Ohio and Pennsylvania, and states in conclusion that:

> On balance, I am not persuaded that the Connecticut, Illinois, Ohio or Pennsylvania statutes, despite their divergent departures from the Georgia Act, should be treated differently. In none are the four corporate characteristics assured beyond doubt; all leave a good many troublesome questions of state law to be answered

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White & Petersen, *Corporate Tax Advantages for Attorneys,* 35 CALIF. STATE B.J. 167 (March-April 1960).

Wolper, *Medical Entities Taxed as Corporations: A New Field,* 15 J. AM. SOC'Y C.L.U. 353 (1961).

Corporate Benefits for Attorneys; Restrictions and Possibilities, 64 W. VA. L. REV. 310 (1962).

New Professional Corporation Laws Explained, CCH 79 CORP. LAW GUIDE (Jan. 30, 1962).

Professional Corporation Legislation — Distinct Approval by the Judiciary, Under Its Inherent Powers Over Attorneys, Also Necessary for Professional Corporation to be Admitted to the Bar, 37 NOTRE DAME LAW. 545 (1962).

Professional Corporations and Associations, 75 HARV. L. REV. 776 (1962).

Qualified Pension Plans for Unincorporated Professional Associations, 12 STAN. L. REV. 746 (1960).

Summary of Report of Special Committee on Incorporation of Law Offices, 37 CALIF. STATE B.J. 473 (July-Aug. 1962).

Ethical Problems Raised by the Association and Incorporation of Lawyers, Am. B. Foundation Research Memorandum Series, No. 28, Nov., 1961, Addenda, June, 1962.

Should Professional Men Practice as Corporations? R.I.A. Planning Report (May 1962).

[16] 17 TAX L. REV. 1 (1961).

in future years; and, for reasons to be set out later, neither the Treasury nor the federal courts should attempt to extrapolate such a formidable corpus of state law in passing on federal income tax claims when this uncongenial task can be avoided.[17]

In reviewing the state professional corporation statutes (including the Florida statute) that have been enacted, Mr. Bittker had the following comments to make:

> In a number of instances, the state legislation under review permits professionals to carry on their practice through 'corporation' or 'professional corporations.' The most direct route to this result would have been to amend the state's general corporation law to override any legislative, common law, or administrative restrictions on the right of ordinary business corporations to practice the profession in question. But the statutes are not so simple, evidently because the state legislatures believed that the nature of professional practice called for restrictions to which ordinary business corporations are not subject. Thus, the statutes preserve the professional relationship and the professional's liability to his patient or client and prohibit the ownership of shares by unlicensed persons.
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> 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 concerned with the classification of organizations that are *not* labeled 'corporations' by state law.
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> The term 'corporation,' however, is not used in the Internal Revenue Code to embrace all organizations to which a state chooses to apply the label 'corporations,' any more than state use of the label 'association' automatically makes the group an 'association' under § 7701(a)(3). Rather, the Code uses the term 'corporation' as a brief summary of a group of legal consequences attached by state law to a business organization. To take an extreme example, if Hawaii were to amend its version of the Uniform Partnership Act by striking out the word 'partnership' throughout and substituting the word 'corporation,' this species of Hawaiian 'corporation' would not be regarded as a 'corporation' for federal income tax purposes.
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> If therefore the state law label is not sacrosanct, the first step in classifying a business organization for federal income tax purposes is to ascertain its legal consequences under state law. This is the method by which we have long determined whether or not an unincorporated group is to be treated as an 'association' and hence as a 'corporation,' and there is no reason to flinch from employing the same process in deciding how a new-style professional corporation shall be taxed. . . .
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> In applying these principles to the professional corporation, I

[17] *Id.* at 25.

feel that most of the remarks and questions in my discussion of the Georgia Professional Association Act are relevant.[18]

Earlier in his article, he had stated the following conclusion:

As will be seen, the two types of statutes [professional association and professional corporation] are not sufficiently different, in my opinion, to warrant different classification in applying the federal income tax.[19]

Although many lawyers, including the author, have serious disagreement with many comments made by Mr. Bittker in arriving at his conclusions, I think it is generally agreed that his attack does strike home when he argues the term "corporation" cannot be loosely applied by state legislatures to negate basic federal income tax concepts. As pointed out by Mr. Bittker, all organizations bearing the label "corporation" under state law have until now been accorded that status for federal income tax purposes.[20] Does this mean that the inquiry will stop there? Probably not. To the extent that the word "corporation" becomes a label without its classical meaning in legal substance, then it would appear the courts will tend to disregard the label and classify the organization through other tests.

However, this is not to say that a "pure" corporation under state law, even though it houses only a sole proprietor, should not be treated as a corporation for federal income tax purposes. Although there is substantial precedent in federal tax law for refusing to subordinate federal tax concepts to state law,[21] this does not mean that the Internal Revenue Service should accord one tax status to business corporations and another to personal service corporations which are organized and operate under the same basic corporate law.

It has been suggested by Mr. Paul E. Anderson[22] of the California Bar that any other rule would open a Pandora's box: If the

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[18] *Id.* at 25-27.

[19] *Id.* at 3.

[20] "Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors, or to serve the creditor's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Moline Properties, Inc. v. Commissioner, 319 U.S. 436, at 438-39 (1943). See also National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Commissioner v. State-Adams Corp., 283 F.2d 395 (6th Cir. 1960); National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944). As mentioned by Mr. Bittker in a footnote, an exception, of course, would be where the corporate entity is disregarded as a "dummy" or "sham."

[21] *E.g.*, see Commissioner v. Tower, 327 U.S. 280 (1946), and Morgan v. Commissioner, 309 U.S. 78 (1940).

[22] Outline by Paul E. Anderson for his talk on Tax Aspects of Professional Corporations, Outlines of Lectures, Fifteenth Annual Institute on Federal Taxation, U. So. Cal. Tax Institute (1962).

Commissioner can classify a "pure" corporation as a partnership (or proprietorship) for tax purposes, why should not its stockholders have an equal right so to do if and when it suits their purpose? (Could not creditors make a similar assertion?) Or can the Commissioner claim that only he has the power to re-classify, viz., that this problem is a one-way street?

In a recent article in the *Tax Law Review*,[23] answering Mr. Bittker's article, Mr. Marcus D. Grayck of the New York Bar disagrees with Mr. Bittker's analysis of the Georgia Professional Association statute. After a review of the four principal characteristics set forth in the Regulations, the author concludes that a professional association under the Georgia Act would have centralization of management, continuity of life, free transferability of interests (in a modified form), and perhaps limited liability. Thus he concludes that such an association would have more corporate characteristics than noncorporate characteristics. As to the professional association statutes generally, Mr. Grayck believes that if a court will look at such statutes "with an open mind, with an absence of preconceptions as to the propriety of pension plans for professional practitioners, and with an ability to accept change in the forms and norms of professional practice, the professional association statutes, in most cases, should be able to meet the requirements of the Regulations."[24]

Mr. John E. Ohl of the New York Bar, in a vigorous paper[25] advocating action by the State of New York, also disagrees with Mr. Bittker on numerous points. He recommends legislation in New York to allow law firms to form joint stock companies or associations, which he believes would qualify them under the existing Regulations for federal corporate treatment. In addition, he states that a prospective ruling from the Internal Revenue Service should be facilitated and the risk of losing any court test greatly minimized by such legislative action.

Developments in California

Although the Board of Governors of the State Bar of California has not yet recommended any specific action as to the professional corporation bill (AB 2733) introduced before the California State Legislature, in 1961 it appointed a committee under the chairmanship of former Commissioner of Internal Revenue Dana Latham to review such legislation and similar legislation in other states and to

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[23] Grayck, *Professional Associations and The Kintner Regulations: Some Answers, More Questions, and Further Comments*, 17 TAX L. REV. 469 (1962).
[24] *Id.* at 489.
[25] Ohl, *Corporate Practice of Law in New York*, 40 TAXES 263 (1962).

make recommendations to the Board of Governors as to a proposed course of action. This study, painstakingly made over a period of many months, resulted in a carefully worded report dated January 15, 1962, which was filed with the Board of Governors late that same month. This report recommended that the Board of Governors sponsor legislation (a Model Act) drafted by the committee to allow lawyers to incorporate.[26] A summary of such report was prepared and published in the July-August 1962 issue of the *California State Bar Journal*.[27] In September 1962 a panel was presented before the California State Bar Convention to present all sides of the issue in oral form and to respond to questions from the floor.[28] To date no action has been taken by the Board of Governors with respect to the report.

The Latham committee started with a basic assumption that sole proprietors were to be included within the scope of any proposed legislation. This assumption makes the whole problem much more difficult, as noted earlier in this article.

As a result of the work of this committee, a Model Act was drafted, together with certain proposed changes to the California Business and Professions Code relating specifically to law corporations. The underlying philosophy of the Model Act is that the professional corporation should be a "pure" corporation in the historic sense. Accordingly, the Model Act provides that the professional corporation is to be incorporated under the General Corporation Law of California. However, in order to become a professional corporation and therefore practice a particular profession, it must, in addition, be certified to do so by the particular administrative agency regulating that profession. As to a law corporation, it would have to be certified by the State Bar of California. Extensive requirements for such certification are proposed as amendments to the California Business and Professions Code. It is believed that these proposed statutory provisions measure up to the requirements for the ethical practice of law by corporations declared by the American Bar Association Committee on Professional Ethics in Opinion 303[29] and provided for in the rules of the

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[26] Of the twelve members of the committee voting on the proposed legislation, nine favored that it be sponsored by the State Bar. One member was opposed in any event. One other was opposed unless specific provisions were included — for example, a prohibition against a professional corporation engaging in any other type of business. A third member was opposed to any kind of action at the present time.

[27] *Summary of Report of Special Committee on Incorporation of Law Offices*, 37 CALIF. STATE B.J. 473 (July-Aug. 1962).

[28] The author was a member of the committee, assisted in drafting the report, and was a member of the panel.

[29] *Supra* note 4.

Supreme Court of Colorado[30] and the Supreme Court of Florida.[31] In fact, I believe a strong case can be made that through imposing strict requirements upon the use of professional corporation legislation, even higher standards of professional responsibility can be achieved. For example, in California it is suggested that malpractice insurance be required of all professional corporations.

It was contemplated that each profession would adopt its particular provisions for certification of a corporation to practice the profession, it being felt it would have been presumptuous for the Bar Association to adopt proposed rules for medical corporations or any other profession than the law.

In summary, therefore, the Model Act provides that a professional corporation may practice the profession in which it proposes to engage only if it has a certificate of registration from the governmental agency regulating such profession, issued pursuant to express provisions of the Business and Professions Code authorizing such professional services to be rendered by a professional corporation. Thereafter the corporation is subject to regulations by such governmental agency pursuant to applicable provisions of the Business and Professions Code. For this reason each profession desiring to avail itself of the provisions of the Model Act must first obtain the necessary amendments of its portion of the Business and Professions Code required to enable a professional corporation to practice that profession and be regulated by that profession's own administrative agency.

Professional Corporation Should Be Enabled to Practice Law

In addition to the statutory provisions mentioned above, it is believed that the applicable statute (as does the California Model Act) must make it as clear as possible that the professional corporation can practice the particular profession, in order to forestall an attack by the Internal Revenue Service that the income is really taxable to the owners and not the corporation. The theory of such an attack, of course, would be that if the professional corporation could not practice the profession, then the income generated by the professional services might be attributable to the owners, who, in turn, have assigned it to the corporation.[32]

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[30] COLO. SUP. CT. RULES 231 (1961).
[31] In the Matter of the Florida Bar, 133 So. 2d 554 (Fla. 1961).
[32] Mobile Bar Pilots Ass'n v. Commissioner, 97 F.2d 695 (5th Cir. 1938), Ct. Dec. 1417, 1939-2 CUM. BULL. 244; The Topeka Insurors, 12 T.C. 428 (1949), *acq.*, 1949-2 CUM. BULL. 3; Rev. Rul. 54-614, 1954-2 CUM. BULL. 271.

Finally, an employer-employee relationship must be established between the professional corporation and its members. In Regulations § 31.3401(d)-1(b) concerning withholding taxes, and Social Security Tax Regulations § 31.3121(d)-1(c)(2), it is stated that the employer "has the right to control and direct the individual who performs the services, not only as to the results to be accomplished by the work but also as to the details and means by which that result is accomplished." However, in the case of professional persons, the test of employment is more "tenuous and general."[33] In this vein, in Rev. Rul. 61-178, 1961-2 C.B. 153, the Service ruled that the test of employment of a physician by an association was:

> (1) the degree to which such individual has become integrated into the operating organization of the person or firm for which the services are performed; (2) the substantial nature, regularity, and continuity of his work for such person or firm; (3) the authority vested in or reserved by such person or firm to require compliance with its general policies; and (4) the degree to which the individual under consideration has been accorded the rights and privileges which such person or firm has created or established for its employees generally.[34]

Chances of Success of a Professional Corporation Organized Under a Statute Such as the Proposed California Model Act

As has been mentioned, the proposed California Model Act would allow sole proprietors to come within its scope. Since a sole proprietor does not have "associates," it probably cannot meet the requirements set forth in the Regulations for corporate status.[35] Assuming that the Internal Revenue Service will try to impose the requirements of such Regulations on a professional corporation before admitting corporate status for federal income tax purposes, then it is obvious that the sole proprietor has the greatest exposure to attack. However, it is believed that state legislation such as the Model Act gives the sole proprietor as much protection as is possible in this area consonant with adequate supervision and control over the professional corporation by the State Bar, and that the remaining risk is inherent in the factual situation itself — the possibility of attack by the Internal Revenue Service against any corporate entity housing a professional sole proprietor whose affairs

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[33] Cody v. Ribicoff, 289 F.2d 394 (8th Cir. 1961); Flemming v. Huycke, 284 F.2d 546 (9th Cir. 1960); Walker v. Altmeyer, 137 F.2d 531 (2d Cir. 1943); Wendell E. James, 25 T.C. 1296, 1301 (1956); Rev. Rul. 57-21, 1957-1 CUM. BULL. 317.

[34] See also Special Ruling, *supra* note 14.

[35] Knoxville Truck Sales & Service, Inc., 10 T.C. 616, 619 (1948), *acq.*, 1948-2 CUM. BULL. 3. See *Can One-Man Professional Associations Qualify Tax-Wise?*, 17 J. TAXATION 318 (Nov. 1962).

are strictly regulated by a governmental agency. In such a context, it is believed that the sole proprietor qualifying under such state legislation has a substantial probability of success against attack by the Internal Revenue Service.

The second level of evaluation would relate to the incorporation of such associations of lawyers as could meet the requirements under the Regulations for corporate status. It is believed that the Internal Revenue Service should, and it is hoped will, grant prospective rulings to such corporations since there does not appear to be any relevant difference per se for purposes of corporate status between such law offices and the Connecticut medical clinic mentioned in the private ruling above.

The third level of evaluation would concern factual situations lying between the first two. Here the professional corporation organized under such state law can argue not only that it is a pure corporation, but also in many cases should be able to argue that it meets the requirements of the Regulations even though the Internal Revenue Service will not so rule. Obviously the probability of success for such a corporation is stronger than that for the sole proprietor, the degree depending upon the particular facts.

Operating Problems of Professional Corporations

It should always be kept in mind that even assuming favorable tax status as a professional corporation, there are numerous tax problems involved in its operation which should be carefully considered. For example, the professional corporation might very well be a "collapsible" corporation, as that term is defined in IRC § 341. It might well have problems of unreasonable accumulations of surplus, or it might face the problem of having certain salary payments being disallowed as excessive. It always must watch the rules as to personal holding company status. One- or two-man professional corporations need special attention as to qualified profit-sharing and pension plans. It is believed sufficient at this point to say that, although serious, it appears that none of these matters can be said to generally dictate against the use of a professional corporation statute by law firms.[36]

Conclusion

Assuming (a) the particular state bar fully apprises all of its members of the tax problems involved, (b) the particular legislation

[36] For a rather complete analysis of these problems, see Report of Comm. on Incorp. of Law Offices, State Bar of Calif., Exhibits D-1(b)&F (Jan. 15, 1962).

is as carefully drawn as possible to meet such problems and to comply with the requirements of Opinion 303 and local canons of ethics, (c) the particular legislation is approved by such judicial body as has jurisdiction over the practice of law, and (d) the members of the particular state bar, through plebiscite or otherwise, indicate that a majority approve such legislation, then it is the author's strong belief that professional corporation legislation should be endorsed by the state bar group to allow a sole proprietor or law firm to incorporate if it so desires. It is undoubtedly true that many proprietors and partnerships will not choose to do so. Perhaps very few will take advantage of such legislation. But should this not be the choice of the proprietor or partnership?

To specifically answer the question in the first paragraph of this article, I do not believe that the existing prohibition in many states against corporate practice is an important principle in safeguarding the high ethical standards of the legal profession.