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How to Salvage Tax Benefits When a Professional Corporation Disbands

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How to salvage tax benefits when a professional corporation disbands

by JOHN W. LEE

One of the main concerns of a shareholder in a professional corporation that is dissolving is to protect his interest in the corporation's qualified deferred compensation plan. By use of a case study, Mr. Lee analyzes several methods available for a shareholder to preserve his interest. He also presents a possible solution to other problems arising in connection with the professional corporation's dissolution, such as splitting up the practice (and its accounts receivable) and the status of liquidating distributions if the professionals reincorporate separately.

PHYSICIANS, P.C., is a professional corporation with three equal shareholders, Doctors Arzt, Fell and Jung. Irreconcilable differences of management philosophy have caused each doctor to want to open his own practice. Physicians, P.C., had established, as of December 1, 1971, the date of its incorporation, a money-purchase pension plan calling for contributions equal to 25% of eligible employees' compensation with a vesting schedule of 20% per complete year of participation. Doctors Arzt and Fell had been in practice together for several years prior to incorporation and Doctor Jung joined the corporation in 1973.

The doctors and the corporation had entered into employment contracts that provided for a severance-pay program upon a termination of employment. Under the agreement an amount equal to 50% of each doctor's non-vested account balance in the retirement plan and an amount equal to one-sixth of the outstanding accounts receivable at the time of his termination of employment would be paid to him as severance pay. Each doctor, at the same time, entered into a buy-sell agreement with the corporation under which he would be paid a premium for his stock, in addition to its book value, equal to 50% of his non-vested interest in the retirement plan and one-sixth of the then outstanding accounts receivable.

In the last quarter of 1976, Doctors Arzt and Fell each have account balances of $150,000, 80% of which is nonforfeitable under the plan's vesting formula. Doctor Jung has an account balance of $75,000, which is currently 60% nonforfeitable.

The three doctors have agreed that patient lists will be divided equally among them, and that the two assistants who work for each doctor will go with them. There is $150,000 in accounts receivable and $30,000 in furniture, fixtures and equipment at this time.

Three choices

Dr. Arzt seeks your advice as to whether he should (1) terminate his employment with Physicians, P.C., and take his severance pay; (2) have his stock redeemed and contribute his lump-sum distribution of his nonforfeitable account to a rollover IRA; or (3) whether he should stay with Physicians, P.C., while the other two doctors terminate their relationship with the corporation.

Severance pay and buy-sell agreements. On the surface, the severance pay would appear to constitute earned income under Section 1348 to Dr. Arzt and be deductible as compensation by Physicians, P.C. The payments received under the buy-sell agreement would appear to qualify as capital gains. However, the Service could raise two different, serious challenges to this treatment of the severance pay. The first would be that regardless of whether the purported severance pay would be reasonable in amount if intended as compensation, it was not so intended and, hence, is not deductible.[1] The challenge would have some merit, but is unlikely to be seriously pursued by the Government, because, while resulting in no deduction to Physicians, P.C., at the same time it would result in capital gains to Dr. Arzt. A more likely, and probably successful, argument, as discussed below in more detail, would be that if Dr. Arzt immediately formed a professional corporation which employed him and his two assistants and commenced to render medical services to former patients of Physicians, P.C., whom Dr. Arzt had been assigned, then the entire transaction would constitute a divisive reorganization under the liquidation-reincorporation doctrine, coupled with a boot-dividend under Section 356(a)(2) of any purported severance pay payment that Dr. Artz retained outside his professional corporation. The redemption premium equal to the severance pay would also be susceptible to boot-dividend treatment. Even if the liquidation-reincorporation doctrine did not apply due to failure to meet any Section 355 requirements, capital gains treatment would probably be barred under the no-complete liquidation theory.

Perhaps even more serious is the probability that the element of the purported severance pay and purported redemption premium corresponding with the withdrawing doctor's forfeitable account balance in the retirement plan would disqualify the plan as discriminating in operation—dual, discriminatory vesting standards for shareholder-employees and for rank-and-file employees. A consequence would be that the nonforfeitable interest of Dr. Arzt would be immediately taxed to him.[2] It might be that instead of disqualifying the plan, the Service would require that all plans, including successor plans, in which any of the doctors were participants, provide for immediate vesting (while not permitting such plans to lengthen their eligibility requirements from the current requirements of the Physicians, P.C., plan to a three-year wait).[3] Additionally, the doctors could expect the Department of Labor to order them removed as trustees and enjoined from serving as trustees on the basis of their proven propensity to fail to follow plan terms,[4] *e.g.*, the vesting schedule. Consequently, the prudent advice to Dr. Arzt would be that he not terminate his employment with Physicians, P.C., in the manner proposed.

Nor can he prudently be advised to remain with the corporation while the other two physicians severed their employment relationship with the corporation under the proposal. At best, if the transaction stood up, the accounts receivable attributable to the two departing physicians would be taxed to the corporation (with a deduction presumably for the severance payments), but the redemption price for their stock would not be deducted by the corporation although it would, if the transaction stood as structured, reduce earnings and profits of the corporation.[5] However, the chances are that it would not stand as structured. In that case the plan of Physicians, P.C., might well be disqualified on the grounds of discrimination in operation in that the prohibited group in practical effect would always be vested while presumably the rank and file employees would not be immediately vested. Moreover, the severance pay payments would probably not be deductible.

Use of individual retirement accounts. Assuming that the entire proposed transaction did not result in a disqualification of Physicians, P.C.'s money-purchase pension plan, there still remains serious doubt as to whether the departing physicians would be entitled to roll over their distributions into a conduit IRA. First, there would quite likely be no requisite separation from service and the amendments provided by P.L. 94-267, 4/15/76, relating to rollovers from terminated plans or from plans where there has been a complete discontinuance of contributions[6] might not apply. Secondly, the five-years-of-participation rule apparently applicable to lump-sum distributions for rollover purposes would not be met.

Under Section 402(a)(5)(A)(i), the participant of a qualified retirement plan is not taxed on a distribution to him if it constitutes a lump-sum distribution as defined in Section 402(e)(4)(A) and provided that within 60 days after his receipt of the distribution, he transfers it to an individual retirement account (IRA) or to the trust of another qualified plan. The applicable provisions of Section 402(e)(4)(A) require that the payments qualify as a distribution of the entire balance to the credit of an employee's account which becomes payable to him "on account of the employee's separation from the service" of a company. The concept of separation from the service of the company has been in the Code since 1954 as a prerequisite to pre-ERISA favorable lump-sum distribution tax treatment.[7] There recently has been a substantial shift in the Government's position as to what constitutes a separation from service when there is any type of reorganization (in its broadest terms) of the employer. In *Rev. Rul.* 72-440, 1972-2 CB 225, the Service ruled that an employee would be considered to have separated from the service within the meaning of the predecessor to Section 402(e)(4)(A) "only on his death, retirement, resignation or discharge, and not when he continues on the same job for a different employer as a result of a liquidation, merger, consolidations, etc., of its former employer."

This Ruling, in the context of a division of a professional corporation, would itself be of little concern but for the fact of the prior Rulings that it expressly overrules, and subsequent Rulings, such as *Rev. Rul.* 73-413, 1973-2 CB 143. There, the Service held that where a corporation, wholly owned by two shareholder-employees, was liquidated and a successor *partnership* was formed to continue the business, the former shareholder-employees (now partners) and the common-law employees who were formerly employees of the corporation and now employees of the partnership did not incur a separation in service which would qualify the distribution from the terminated corporate retirement plan as a lump-sum distribution. Furthermore, the Service had earlier ruled in *Rev. Rul.* 58-98, 1958-1 CB 202 (specifically revoked by *Rev. Rul.* 72-440) that a separation in service occurred where a corporation was liquidated and the business continued by the shareholder-employees as a partnership. In short, where a professional corporation is liquidated and the same business continued in a professional partnership there would be no separation from service for lump-sum distribution purposes. Additionally, in *Rev. Rul.* 58-97, 1958-1 CB 201 (also revoked by *Rev. Rul.* 72-440), the Service had previously held that where incident to a plan of complete liquidation, the assets used in carrying on the business of one of two divisions of the corporation were sold to another corporation and the plan terminated as to those employees, there was a separation from service. The revocation of this Ruling indicates that continued employment with a spun-off or split-off division precludes a separation from service. Reading all of these Rulings together, it would appear that if a professional corporation were split-up, say into two or more partnerships or through a divisive reorganization into two or more professional corporations, each owned separately by the former shareholder-employees, there would be no separation from service as to employees continuing employment with one of the divisions of the former professional corporation. Without a separation from service, there is no rollover availability as such unless the plan termination rules apply.

Under Section 402(a)(5)(A)(i), as amended by P.L. 94-267, rollover treatment is accorded, as an alternative to meeting the Section 404(e)(4)(A) "lump-sum" definition, on account of termination of a pension plan (or on account of a complete discontinuance of contributions in the case of a profit-sharing or stock bonus plan). Here, however, the money-purchase pension plan of Physicians, P.C., is not being terminated. Fortunately, Congress also addressed the situation where the plan continued to exist but many employees have been forced to leave the plan. A careful reading of new Section 402(a)(6)(B) and its legislative history nevertheless reveals that a tax-free divisive reorganization in which the spun-off or split-off business was not previously operated in a subsidiary, but instead constituted either an integral part or a division of the controlling corporation's business is not covered by the new legislation. In such circumstances there is neither a separation from service nor a constructive termination. The only rollover permitted by Section 402(a)(5) in this situation would be where the plan is terminated.

Apart from the separation-from-service hurdle, where there is no termination of a plan, it appears that five years of participation in the plan (which none of the doctors have) is a prerequisite to rollover or conduit IRA treatment where there is no plan termination. The statutory construction argument supporting this position is that Section 402(e)(4)(H), in requiring five years of participation for a distribution to qualify as a lump-sum distribution, expressly states that it does not apply to Section 402(a)(2) (capital gains treatment for portion of lump-sum distributions) but makes no refer-

[1] See, e.g., *Irby Construction Co.*, 290 F.2d 824 (Ct. Cls., 1961).

[2] Sections 402(b) and 83(a).

[3] Section 410(a)(1)(B)(i) permits plans providing for immediate vesting to require completion of three years of service for participation. However, in cases of patterns of abuse or misuse, the Service would appear to have authority to require immediate vesting (See Conf. Rep't. No. 93-1280, 93d Cong., 2d Sess. 276 (1974)) and at the same time seemingly could require the plan to grant entry to future employees after satisfaction of a minimum service no greater than required of the prohibited group in order to prevent discrimination in operation as to eligibility. See Pub. 778, Part 4(e) (1972); *Rev. Rul.* 70-75, 1970-1 CB 95.

[4] See ERISA, Sections 502(a)(2), 409(a), and 404(a)(1)(D).

[5] See *Enoch*, 57 TC 781 (1972).

[6] These provisions are discussed in McKinney, *Analysis of the newly expanded rollover provisions for terminated qualified plans*, p. 10 of this issue.

[7] See Section 402(a)(2) prior to enactment of ERISA.

ence to Section 402(a)(5) ("rollover amounts"). Conversely, Section 402(a)(5) expressly states that the Section 402(e)(4)(B) requirement for a lump-sum distribution (an election of lump-sum treatment) does not apply, but fails to mention the minimum participation requirement of Section 402(e)(4)(H). Clearly members of the House Committee on Ways and Means believe that the five-years-of-participation rule applies to lump-sum distribution rollovers.[8]

Partial termination and direct rollovers. As discussed above, any attempt to give the separated shareholder-employees the effect of immediate vesting outside of the plan's terms under the application of normal IRS rules ultimately should result in either disqualification of the old plan, or in the post-ERISA climate more likely trigger a requirement of immediate vesting (in order to prevent further discrimination in operation because of abuse) as to the old plan, and as to any successor corporate plans of any of the doctors. Yet, there is a recently emerging trend which would require immediate vesting as to the accounts of the separating shareholder-employees and the employees who go with them, that would not require immediate vesting as to the employees who remain with Physicians, P.C., and should not require immediate vesting as to new participants in any corporate plans established by the departing doctors in their new professional corporation. Namely, under the doctrine of partial termination, the funded accrued benefits of participants who are no longer covered by corporate plans due to a partial termination are immediately vested,[9] while the remaining participants are not so vested. This approach should eliminate some of the pressure for severance pay or redemption premiums and their attendant risk.

In *Rev. Rul.* 72-510, 1972-2 CB 223, an employer closed down one of two divisions of its business at a time when its retirement plan covered 155 employees; 95 of the employees in the closed-down division were discharged. The Service held that the "significant number" of discharged employees constituted a partial termination of the plan triggering a requirement of full and immediate vesting of the funded benefits of the employees of the closed-down division.[10]

A split-off of a professional corporation with one or more professional employees taking their assistants and the patients that the doctors had attended with them, would appear to constitute the closing down or disposal of a division of the old professional corporation. Consequently, the plan of Physicians, P.C., should be partially terminated as to the employees who leave with a particular doctor's practice and their interests in the plan should be immediately vested. The result should have no effect upon the employees who remain and should not preclude the split-off division from establishing its own plan and requiring graded vesting as to employees and as to further contributions or accruals as to existing employees and participants.

Immediate vesting of the terminated employees' interests without disqualification of the existing plan, while still permitting graded vesting for new participants and further contributions as to participants in the plans of the split-off divisions and the old corporation, does not of itself solve the problem of transfer of the vested interests of the terminated employees from the Physicians, P.C., to retirement plans of successor professional corporations. There still is not the requisite separation from service or termination or constructive termination. Even were the old plan terminated and new plans adopted by the three successor corporations, in this instance there might be some doubt as to whether there would have been a termination of the predecessor plan. The easy answer to the transfer problem is to be found in the pre-ERISA law.

The Service has ruled[11] "that if funds are transferred directly from one qualified retirement plan to another without the consent of the participants, i.e., a direct roll over, the funds are not "made available" under Section 402(a)(1)—a doctrine virtually identical to that of constructive receipt. Similarly, if plan funds are delivered to participants who must, under an enforceable agreement, turn the funds over to the new plan, no tax will be imposed upon their transitory passage through the hands of participants.[12] However, if participants are allowed to determine whether their funds should be distributed to them outright or transferred to a new plan, and there is no penalty imposed upon election of an outright distribution, the participants who chose the transfer will nevertheless be deemed to have constructively received the amounts they elected not to take.[13] Accordingly, with careful planning, the retirement accounts of the employees who go with the departing doctors may be directly transferred to plans established by the new divisions without triggering Federal taxation upon the transfer.

In summary, a combination of treating the departing division as a partial termination of the Physicians, P.C., retirement plan with direct rollovers of their vested interest to plans established by a new professional corporation, organized by the doctor in each departing division, can give the departing doctors' their entire account balance, fully vested, without income tax imposed upon the transfers. At the same time, it would appear that the old plan and the new plans can continue to provide graded vesting for new contributions and new participants.

Split-offs under Section 355

In addition to the problem of splitting up the retirement plans, there is the problem of splitting up the professional practice and particularly the accounts receivable. If the accounts receivable are maintained in Physicians, P.C., and then amounts are paid to the withdrawing doctors, Physicians, P.C., can be taxed on the accounts receivables as they are collected. Any distribution to the withdrawing shareholders of the accounts receivable in redemption of their stock also would trigger income to the corporation.[14] Assuming that the redemptions were not collapsed into a reorganization under the liquidation-reincorporation doctrine, Physicians, P.C., would still be taxed on a distribution of the accounts receivable. It is clear that in a liquidation or partial liquidation, which the

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proposed transaction probably would constitute, accounts receivable distributed to the withdrawing shareholder are taxed to the distributing corporation under the assignment-of-income doctrine. The Government also has another arrow in its quiver, having scored some success under the clear-reflection-of-income doctrine derived from Section 446 in the context of assignment of items that a cash-basis liquidating corporation had earned but had not yet brought into income.[15] There is, however, an answer to the accounts receivable problem which is in accordance with the underlying reality, both economic and tax, of what occurs in splitting up an incorporated professional practice.

If Physicians, P.C., in connection with the transfer of a going business, i.e., the practice of one of the doctors, transfers the accounts receivable attributable to that doctor to a newly formed subsidiary in exchange for all of its stock in a Section 351 transaction (preparatory to a Section 355 split-off), the accounts receivable assigned in bulk to the corporation are not taxed under the assignment-of-income doctrine to the transferring corporation.[16] The existing authorities speak to a transfer in connection with incorporation of a going business and, accordingly, employment contracts of the parting physician and his assistants should also be transferred to the newly formed subsidiary.

Next, the goal would be to distribute the stock of the newly formed subsidiary to the departing physician in exchange for all of his stock in Physicians, P.C. If Section 355 is applicable, the withdrawing shareholder-doctor would not be taxed upon the excess of the fair market value of his stock in the distributed corporation over his basis in the old corporation.

Section 355 provides that immediately before a distribution, the distributing corporation, here Physicians, P.C., must control the corporation whose shares are being distributed. Immediately after the distribution, both the distributing corporation and the controlled corporation or corporations must be engaged in the active conduct of the trade or business. Such trade or business must have been actually conducted throughout the five-year period ending on the date of distribution and cannot have been acquired within such five-year period in a taxable transaction. The distributing corporation must distribute at least the "controlling stock" and securities in the controlled corporation and the transaction must not be used principally as a device for the distribution of earnings and profits. In addition, the IRS would require that the transaction have a business purpose and the continuity of interest doctrine be satisfied.[17] The management disagreement between the three doctors here should satisfy the device restriction and the business purpose requirement, particularly since the distribution would be non-prorata. As to the two withdrawing doctors there would be a termination of their interest in the old corporation.[18] The first essential question, then, is whether the five-year-active-business requirement can be met.

The starting point is that Physicians, P.C., is not yet five years old. However, this is not in itself a critical factor. For the five-year-active-business requirement does not require that the controlling corporation have conducted the business for five years or that the controlling corporation be five years old. What is demanded is that the business which is split-off be at least five years old and have been conducted actively for five years. In *W. E. Gabriel Fabrication Co.*, 42 TC 545, (1964), *acq.*, the Tax Court squarely held that Section 355 does not require that the actively conducted business have been directly conducted by either the distributing corporation or the controlled corporation for the purposes of the five-year-predistribution-business requirement. The business conducted by Dr. Arzt and Dr. Fell has been conducted for more than five years at the time of the split-up; however, Dr. Jung has been in practice only three years. This poses the question of whether a single business was involved, which has been split into three portions or whether there were three different businesses, one of which was less than five years old.

Originally, the Treasury espoused the position, in Reg. 1.355-1(a), that the active business requirement of Section 355(b) required that each post-distribution business was itself a separate actively conducted business for five years prior to the distribution. The courts disagreed and ultimately the Service agreed to abide by the judicial decisions "to the extent they hold that Regs. 1.355-1(a), providing that Section 355 does not apply to the division of a single business, is in doubt."[19] With this concession, the contentions of taxpayers and the Government ironically were reversed, with taxpayers arguing that where there was an expansion that was less than five years old, a single business was involved that was being vertically split, but the Government would argue that each business was separate and that the less-than-five-year old business could not pass Section 355. Particularly if Physicians, P.C., did not have multiple offices, since the doctors were all in the same specialty and could substitute for each other as to the same patients, the single business argument will probably prevail and a split-off of Dr. Jung's practice is permissible. As precaution, however, the transaction should be structured as a split-off and Dr. Jung's business should be split off first. Then, either Dr. Fell or Dr. Arzt can split off from Physicians, P.C.

There may well be, however, in many jurisdictions a technical problem in meeting the requirements of Section 355. Section 355 contemplates that the controlling corporation distribute stock in a subsidiary to the withdrawing shareholder (in the case of a split-off) in exchange for all of his stock in the controlling corporation. However, some state professional corporation statutes, preclude anyone other than individual professionals from being shareholders in

[8] H. Rep't. No. 94-1020, 94th Cong., 2d Sess. 25 (1976) (supplemental views of Rep. Vanik); 122 Cong. Rec. H. 3302 (colloquy between Reps. Vanik and Conable). The five-year requirement for lump-sum rollover treatment may be reconsidered. *Id.* (Rep. Ullman).

[9] Temp. Regs. 11.411(d)-2(a)(1) and (b).

[10] See generally, McKinney, *Partial terminations of qualified plans: When do they occur? What are the problems?*, 40 JTAX 82 (February, 1974).

[11] *Rev. Rul.* 68-160, 1968-1 CB 167, *Rev. Rul.* 55-427, 1955-2 CB 27.

[12] *Rev. Rul.* 55-368, 1955-1 CB 40.

[13] *Rev. Rul.* 55-317, 1955-1 CB 329. See Metzer, "Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation," 29 *Tax L. Rev.* 525, 547 (Spring, 1974).

[14] A redemption satisfying the requirements of Section 302(b) is treated as an exchange under Section 302(a) and a sale or exchange of accounts receivable by a cash basis taxpayer triggers income under the assignment of income doctrine.

[15] See Reg. 1.346-2; Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, 11-48, 11-49 (3d ed. 1971).

[16] *Hempt Bros., Inc.*, 354 F. Supp. 1172 (DC Pa., 1973), *aff'd.* 490 F.2d 1172 (CA-3, 1974), *cert. den.*

[17] See *Rev. Rul.* 75-337, 1975-32 IRB 10; Note, "Developing an Independent Role for Business Purposes and Continuity of Interest in Section 355 Transactions," 44 *Cinn. L. Rev.* 286 (1975).

[18] See e.g., *Badanes*, 39 TC 410 (1962); *Rev. Rul.* 71-593, 1971-2 CB 181; *Rev. Rul.* 64-102, 1964-1 CB (Part 1) 136.

[19] *Rev. Rul.* 64-147, 1964-1 CB (Part 1) 136; *Coady*, 35 TC 771, *aff'd.* 289 F.2d 490 (CA-6, 1961); and *Marrett*, 325 F.2d 28 (CA-5, 1963).

[20] *Morris Trust*, 367 F.2d 794 (CA-4, 1966).

[21] *Rev. Rul.* 75-406, IRB 1975-38, 7.

[22] See McQuiston and Ballard, *Current status of the liquidation-reincorporation problem*, 31 JTAX 328 (December, 1969).

[23] Reg. 1.346-2.

a professional corporation and do not have any provision for a regular or non-professional corporation converting into a professional corporation. Thus, forming a subsidiary of the old professional corporation and dropping in the practice (accounts receivable, employment contracts, patient lists etc.) then splitting it off by distributing it to the withdrawing doctor in exchange for all of his stock in Physicians, P.C., presents technical difficulties. The subsidiary cannot qualify as a professional corporation and a regular corporation cannot carry on the profession in question. How then can the split-off subsidiary be engaged in the active conduct of the professional's business immediately after the distribution? The answer lies in combining an amalgamating reorganization with the divisive reorganization in jurisdictions that permit a professional corporation to merge with a regular corporation (provided that the professional corporation is the survivor). The withdrawing doctor should form his own professional corporation shortly before the split-off into which he merges the split-off regular corporation immediately after his receipt of its stock, with the professional corporation being the survivor. In this case, the business of the withdrawing doctor will be actively conducted by the surviving professional corporation which would have the employment contracts. This split-off cum-merger comports with the active-business requirement of Section 355 since the split-off business is continued indefinitely and there is continuity of shareholder interest.[20] Indeed, the Service has ruled that the spin-off of a subsidiary followed by a merger with the spin-off of a subsidiary into an acquiring corporation qualified as both a valid Section 355 transaction and a valid merger.[21]

Liquidation-reincorporation

One may ask whether it is necessary to go through all these prolix steps. The answer is that where the tax adviser does not intentionally structure the break-up of a professional corporation as a Section 355 split-up or split-off with *all* of the assets remaining in corporate solution, he runs the risk that the IRS will restructure the entire transaction as a Section 355 transaction for him under the liquidation-reincorporation doctrine and tax any assets not remaining in corporate solution as boot dividends, whether labelled severance pay or redemption price.

The liquidation-reincorporation controversy traditionally arises when the liquidation of a corporation ("Old Corporation") is accompanied by the transfer of some or all of its operating assets or business to another corporation ("New Corporation") owned by some or all of the same shareholders. The three most common forms in which this may occur are as follows: (1) Old Corporation liquidates, with its shareholders then transferring some of the distributed assets to New Corporation, which they control. (2) Old Corporation forms New Corporation, as a subsidiary, transferring operating assets to it and then liquidates. (3) Old Corporation sells its operating assets during the 12-month period after the adoption of the plan of complete liquidation to New Corporation, which is owned by the same shareholders as Old Corporation and then liquidates.[22] The Commissioner naturally objects to the awarding of capital gain and stepped-up basis of benefits to shareholders when, in fact, the same business is continued in corporate form by some or all of those shareholders. Under the 1954 Code the Government has attempted, therefore, to impose dividend treatment on shareholders as to distributions in the above types of transactions and to deny a step-up in basis as to the assets which continue in corporate solution on a number of theories. Its principal contentions in recent years, usually presented in the alternative, are (1) that the entire transaction constitutes a reorganization (usually under Section 368(a)(1)(D), and (2) that "no complete liquidation" within the meaning of Section 331 has occurred if substantially the same shareholders continue the business of the liquidated corporation in a corporate solution.

The consequences of the entire transaction, constituting a reorganization, are that the amounts distributed to the shareholders that do not remain in corporate solution constitute "boot" dividends, presumably, essentially equivalent to a dividend under Section 356. Of course, such dividends would not be deductible by Old Corporation. Under the reorganization provisions that would be applicable to such transactions, the transferee or New Corporation generally would not obtain a stepped-up basis for the Old Corporation's assets transferred to it, but instead takes such assets at their basis in the hands of the Old Corporation under the transferred basis provisions of Section 362(b).

To date no liquidation-reincorporation has been held to constitute a divisive reorganization under Section 355. Yet in the situation in which the five-year-old practice of a departing doctor is in practical effect distributed to him in exchange for his stock and he then immediately incorporates that practice, the only ingredient technically missing for a Section 355 split-off is the pre-distribution incorporation of that practice by the old professional corporation and then its distribution of the subsidiaries' stock. The failure to issue stock has not been a barrier to application of the liquidation-reincorporation doctrine in the past. For example, in *James Armour, Inc.*, 43 TC 295 (1964), a corporation sold all of its operating assets to a sister corporation owned in the same proportions by the same shareholders. The Tax Court found a "D" reorganization coupled with a boot dividend by holding that an actual exchange of stock was unnecessary, because the shareholders already owned 100% of both corporations, so issuance of additional stock would be a meaningless gesture, and substantially all of the assets were transferred within the meaning of Section 354(b)(1)(A). In the common situation where the departing professional receives his employment contract, his assistants, patient lists, and even accounts receivable, in the form of severance pay or redemption in a purported redemption, and then the professional promptly (and as part of a pre-arranged step) incorporates all but the cash received or to be received, it would be surprising if a court declined to apply the liquidation-reincorporation doctrine and find a Section 355 transaction. The absence of 100% common ownership and the inability under state law to form and, hence, split-off a subsidiary professional corporation should not constitute critical factors. But at least the Tax Court probably would not need to go that far.

A redemption that would constitute a partial liquidation is treated as a partial liquidation.[23] In *Telephoning Answering Service*, 63 TC 423 (1974), a divided Tax Court held that the Section 337 requirement that "all of the assets of the corporation" must be "distributed in complete liquidation" evidenced an intent by Congress to require a bona fide elimination of the corporate entity and did not include " a transaction in which substantially the same shareholders continue to utilize a substantial part of the directly-owned assets of the same enterprise in uninterrupted corporate form." It buttressed this conclusion with the statements in *Pridemark*, 345 F.2d 35 (CA-4, 1965) and *Davant*, 366 F.2d 874 (CA-5, 1966) which stated (in the context of Section 331) that a complete liquidation contemplated that the operating assets would no longer be used by the shareholders to carry on the business as a corporation. The majority found that the transactions in question in *Telephone Answering Service* did not meet these standards since the businesses which Old Corporation directly operated were continued without interruption by New Corporation with substantial continuity of shareholder interest. The majority in *Telephone Answering Service* emphasized that it was dealing only with the question of non-recognition of gain at the corporate level under Section 337 and not with the tax consequences of the transaction at the shareholder level—"in view of the complexities involved in determining those consequences, under a variety of permutations and combinations, it is conceivable that they might be subjected to a different analysis." It would appear that the dissent which held that the no-complete-liquidation doctrine should either be consistently applied, or rejected, at the corporate (Section 337) and shareholder (Section 331) levels took the proper approach. If ever a court would be tempted to apply the no-complete-liquidation doctrine at the shareholder level (denying capital gains treatment to any "redemption" proceeds) it would be in the split-up professional corporation situation where all of the doctors continue to practice in corporate form with essentially the same patients in the same locality.

Boot-dividends. Assuming that Section 355 would apply through the liquidation-reincorporation doctrine to the proposed "redemptions" of the doctors withdrawing from Physicians, P.C., the question remains whether any cash bailed out as severance pay or "redemption' proceeds would constitute boot-dividends. Section 356(a)(1) and (2) provide that if Section 355 would apply to an exchange but for the fact that property other than non-recognition property (i.e., stock) is received, gain will be recognized to the extent of the other property or boot; and such boot will be treated as a dividend (to the extent of E & P) if the exchange "has the effect of the distribution of a dividend." *Revenue Ruling* 74-515, 1974-2 CB 118, signaled the end of the Service's position that a Section 356(a)(2) distribution automatically had the effect of a dividend and an acceptance of the approach of looking to the principles for determining dividend equivalency developed under Section 356(a)(2) and other Code provisions, such as whether the transaction resulted in a meaningful reduction of the shareholder's proportionate interest.

In *Rev. Rul.* 75-83, IRB 1975-11, 6, the Service reaffirmed that in testing for dividend equivalency it is appropriate to look at the principles developed under Section 302, but continued that "in applying the principles of Section 302 in this context, the distribution is treated as though it were made by the acquired corporation . . . and not the acquiring corporation." If this approach were applied by the Service to a divisive reorganization, then any distribution deemed made by the new professional corporation would have the effect of a dividend, since there would be no reduction in the doctor's equity ownership in his professional corporation. Looking at the distribution as if made by the controlling corporation, *Wright*, 482 F.2d 600 (CA-8, 1973), on the surface, might support a no-dividend-equivalency conclusion on the grounds that there was a complete termination of interest as to the departing shareholders. But a closer reading of *Wright* would suggest that dividend equivalency be determined by comparing the equity ownership in the pre-distribution single professional corporation with the equity ownership in the post-distribution professional corporations on a consolidated basis. Before the proposed transaction, each of the doctors owned one-third of Physicians, P.C. After the transaction, each will own all of the stock of a single professional corporation, which realistically must be viewed as one-third of the pre-break up business. If a shareholder owned one-third before and one-third afterwards and has extracted from corporate solution the liquid assets at the time of the division, e.g., the accounts receivable, this clearly should constitute a bail-out and be treated as a dividend.

Conclusion

A decade ago the battlelines were drawn between professionals and the Commissioner as to whether a professional corporation should be treated as a corporation for tax purposes. The Service conceded that battle in 1969. Professionals and their advisers who now ignore their earlier victory when it comes to splitting up a professional corporation surely do so at their peril. The essence of the liquidation-reincorporation and dividend equivalency doctrines is to tax as a dividend assets that are extracted from the corporation while the underlying business remains in corporate solution and the proportionate equities in the post-reorganization corporation remains undisturbed. Viewed on a consolidated basis this is precisely what occurs in the usual division of the professional corporation. Accordingly, wherever the professional practice, if it can be treated as a single business that has been actively conducted for five years (and was not acquired by the professional corporation in a taxable transaction), or if not, that each component has a five-year active business history, a Section 355 division should be seriously considered. If the five-year-active-business requirement cannot be met, serious consideration should be given to practicing as a sole proprietor or partner until incorporation would not trigger the no-complete-liquidation doctrine. In that case, instead of a direct rollover of the plan assets, a frozen or wasting trust or distribution of annuity contracts might be used. ☆

New decisions

Plan contributions allowed (Pre-ERISA). *(DC)*

Taxpayer contended that while its pension trust was overfunded for 1968 and 1969, its contributions were nonetheless deductible since it relied on statistical conclusions reached by a reputable actuary. The Government disallowed the deductions.

Held: For taxpayer. The Government was not free to disallow deductions for past overfunding; it could only prescribe lower future contributions. In other issues, the court barred an investment credit and double declining depreciation for property found to be intangible (seismological information recorded on tapes) rather than tangible (computer tapes). A Western Hemisphere Trade Corporation that filed a consolidated return with non-WHTCs was nonetheless entitled to carry forward its unused foreign tax credits. *Texas Instruments*, DC Tex., 1/20/76.