The Future of Personal Service Corporations: Is There Life After TEFRA?

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INTRODUCTION

The Employee Retirement Income Security Act of 1974 (ERISA) was enacted after hearings and discussions spanning several years. At the time of its enactment most persons assumed that ERISA would be "the" federal law with respect to employer sponsored retirement plans for many years. ERISA caused the wholesale revision of then existing retirement plans. The regulations, rulings and decisions spawned by ERISA caused further revisions of retirement plans and retirement plan thinking.

Those responsible for designing and administering retirement programs had a rude awakening in 1982 when they learned that Congress was on its way towards a further revision of the rules with respect to employer sponsored retirement plans. ERISA was less than eight years old and many regulations with respect to ERISA still remained to be issued in final form.

Early in 1982 Senator Robert Dole, the Chairman of the Finance Committee, made several public statements decrying the fact that "wealthy professionals" were able to put away large tax deductible contributions into retirement plans furnishing benefits at retirement in excess of $136,000. These statements were repeated by Senator Dole and others so often that many unsophisticated persons jumped to the conclusion that all professionals were putting away $45,000 per year in deductible pension plan contributions and were going to receive annual pensions at some early retirement age of over $136,000 per year. It is my observation (based upon my own experiences and also based upon discussions with other attorneys active in the qualified retirement plan area) that taxpayers (whether or not professionals) putting away the maximum (or anything close to the maximum) in qualified retirement plans were the exceptions rather than the rule.

Many sophisticates in the retirement plan area assumed that because Senator Dole's comments in this regard seemed so "unrepublican" they were not to be taken seriously. The doubters have since learned better.

On May 19, 1982, Congressman Charles Rangel of New York introduced H.R. 6410. That bill would have made a great number of changes with respect to the taxation of benefits under retirement, welfare and other fringe benefit programs. The principal changes in this area which would have been adopted under H.R. 6410 (generally referred to as the Rangel Bill) were:

1. The limits on annual additions to defined contribution plans would have been reduced from $45,475 to $30,000 and the limits on annual

1 P.L. 93-406, approved 9/2/74.
benefits under defined benefit plans would be reduced from $136,425 to $90,000.

2. The so-called 1.4 rule (with respect to persons covered under both defined benefit and defined contribution plans) would have been changed to a 1.0 rule.

3. There would have been required actuarial reductions in limitations for retirements prior to age 65.

4. All plan loans to key employees would have been treated as taxable distributions.

5. All of the social security integration rules would have been drastically changed.

6. The estate tax exclusion for death benefits under qualified retirement plans would have been limited to $500,000.

7. The limitation for Keogh plans for the self-employed would have been raised to $30,000 but personal service corporation plans would have been subjected to Keogh rules.

On June 10, 1982, the Ways and Means Committee held an all-day hearing with respect to the Rangel Bill. The Treasury Department gave guarded approval to many features of the Rangel Bill but most of the private sector witnesses opposed the bill.

Immediately following the Ways and Means Committee hearings on the Rangel Bill, "the action" with respect to retirement plan revisions moved to the Senate Finance Committee. At about that time, the Finance Committee began considering tax increase legislation which eventually was designated H. R. 4961 and enacted as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).² Although the Finance Committee did not hold public hearings with respect to any of the pension revision parts of H. R. 4961, it soon became obvious that the Treasury staff and the staffs of the Joint Committee and the Finance Committee were putting together a pension reform package to be included in TEFRA.

On July 12, 1982, the Finance Committee reported out H.R. 4961 (still without any public hearings). This bill contained a pension reform package providing:

1. Cut backs to $30,000 and $90,000, respectively, in limitations on contributions and benefits under defined contribution and defined benefit retirement plans.

2. A phased in increase in Keogh limits to $30,000 in 1985.

3. An elimination of cost of living adjustments for contribution or benefit limitations until 1986.

4. A requirement of actuarial reductions for retirement before age 62—contrasted with before age 65 in the Rangel Bill.

5. A reduction of the 1.4 rule to a 1.25 rule for dollar limitation purposes only.

6. A $10,000 limitation on plan loans to participants.

The Finance Committee bill did not embody the Rangel bill provisions imposing Keogh limits on personal service corporations.

² P.L. 97-248, approved 9/3/82.
After only minor modifications in the pension plan provisions of H. R. 4961, that bill passed the Senate. Almost immediately thereafter the House voted to go to conference on the bill with no further consideration of the legislation by the Ways and Means Committee.

While the bill was still pending in the Finance Committee, rumors and reports began to circulate that there was a deal in the making under which in exchange for the private sector's acceptance of special limitations on so-called "top heavy" plans there would be complete parity in the retirement plan area for the self-employed.

On August 17, 1982, the Conference Committee reported out TEFRA complete with top heavy plan rules and what was touted as parity for self-employed retirement plans starting in 1984.

It is not my purpose in this paper to do an exposition of all of the pension plan revisions which found their way into TEFRA. Rather, it is my purpose to state what I perceive to be the prognosis for personal service corporations now that we have TEFRA. The point to a recital of the history of the pension reform provisions of TEFRA is to lay some ground work for predictions as to what may happen in the future in the same area. Those who worked with Congressman Rangel in drafting his pension reform bill did not get everything they wanted in TEFRA. Accordingly, it is reasonable to assume that sooner or later those who were somewhat disappointed in the TEFRA result will try again to get more reform enacted. Already, there are hints of this.

In the October 18, 1982 issue of Fortune magazine, there was a feature story (at page 126) titled "Bob Dole Wants to Raise Your Taxes Again". At page 140 of the article, it is stated that Senator Dole is considering imposing a withholding tax on corporate contributions to (repeat to) pension plans.

On October 13, 1982, Congressman Rangel told a meeting of the American Society of Pension Actuaries that the Ways and Means Committee would likely hold hearings in 1983 on pension reform and that such hearings would be looking not to a review of TEFRA, but to other reforms.

There are reports to the effect that various members of Congress are considering legislation to impose faster vesting for pension benefits (presumably to meet the complaints of women employees that they do not have uninterrupted periods of service sufficient to acquire valuable vested benefits) and to give nonworking spouses federally guaranteed rights in working spouses' pension benefits. All of this indicates that we are not through the worst in terms of redoing and rethinking retirement plans—we are merely in the eye of the storm. This is disturbing for a number of reasons.

First, planning for worthwhile retirement programs should be a long-range operation. Of all areas of planning, this area is particularly dependent on stability and predictability. With ever increasing numbers of (and more frequent,) revisions in statutes, regulations, rulings and court decisions, the retirement planning community is unable to give meaning-
ful predictions to employers or employees regarding what plans will "work" or be usable for "the course."

The second reason why this is disturbing is that the proponents of constant revision seem to overlook the fact that at least up until this point in time, most businesses are not compelled by law or by collective bargaining agreements to maintain qualified retirement plans. As the game becomes more complex, and as the rules shift from day to day, more and more employers are reluctant to become involved with long-range retirement plans which turn out to require annual (and sometimes more frequent) revisions.

There is a third reason why these developments are untoward. The acceleration of tinkering with the rules applicable the private pension system is occurring just at the time when the social security system is tottering on the brink of disaster and will have to be revised by either drastically increasing tax support for the system or drastically reducing benefits, or both. Surely, there could not be a worse time to discourage the establishment or continuation of private retirement plans.

THE IMMEDIATE PROSPECTS FOR ALL BUSINESSES

Before discussing the prospects for incorporated personal service businesses, I will state what I see as some immediate prospects for the private retirement system generally.

With the new limitations on deductible contributions and allowable benefits under qualified plans, those businesses in which the principals have been at or near the top of the old limitations, will be scaling back their contributions and benefits for all employees. The same will be true of employers who are faced with compliance costs which are escalating beyond their budgets. This will not be done in the spirit of getting revenge on the rank and file for what Congress did to the key employees. Rather, it will follow as a simple law of economics which one cannot repeal, i.e., when Congress tells the owner of the business that he can only contribute 10% of his cash compensation to a retirement plan, he is unlikely to maintain a plan paying substantially higher percentages for other employees. Like it or not—that's life.

The next fallout is going to be that more and more employers will question the wisdom of incurring the expense and hassle associated with establishing funded qualified pension plans only to be told annually, or more often, that the job has to be redone to comply with new statutes, regulations or rulings. Instead, more and more of the principals in private business will be looking for retirement plans which do not run the risk of being constantly torn apart by revisions in the rules. Alternatives to qualified retirement plans which are looking better and better to owners of more and more businesses are:

1. Unfunded non-qualified retirement plans through simple contracts with key employees.
2. Permitting key employees to become equity owners with arrangements for buyouts of equity interests at retirement or death, with the
These alternatives are not without their own problems. Obviously, in an unfunded non-qualified retirement program the potential retiree and his beneficiaries are at risk. If the business flounders, these retirees and their beneficiaries stand in the position of creditors who may or may not get anything under the plan.

At one time, it was assumed that the promise of a giant corporation was as good as gold. Accordingly, a person having an unfunded pension promise from a large corporation could feel the same sense of security he would have if his employer had a fully funded qualified pension plan. Today, not as many people are willing to make such grand statements about the good as gold aspects of large corporate pension promises. Some corporations which everyone assumed twenty years ago could last through anything, are today out of business or nearly so.

However, this "at risk" disadvantage is not so critical to the principal in a small business. I'm not saying that there is not the same or a greater risk of failure of a small business—I'm saying that the principal in a closely held business is usually not as concerned about the risk. That may seem paradoxical. However, most owners of small closely held businesses recognize from the outset that their failure is largely wrapped up in their own business. They are resigned to the fact that they are either going to make it or not make it depending on their own abilities. If the business fails, the owner recognizes that as a risk he took when he started his own business. The owner of a small business also reasons that he has control of his own destiny and if the business fails, he has no one to blame but himself. The same is not true of the executive in a publicly held corporation.

If a business controlled by one or two people fails, each of them has lost much more than the prospect of a retirement payment from the company—he has often lost his entire life savings. Accordingly, the owner of a small business tends to be more philosophic about the matter when an advisor warns him that if his retirement plan is unfunded, he may lose his pension benefits. On the other hand, an executive of a large publicly held corporation does not have the same attitude about the prospect of his employer corporation going under. To him, the loss of future retirement benefits may be the sole risk he faces in connection with the possibility of his employer going broke. For that reason that risk bodes larger in his thinking.

Another reason why unfunded retirement programs are gaining in popularity has to do with the difficulties of raising capital. Small businesses have always been largely dependent on internally generated capital for survival and growth. The principal source of outside financing has been through borrowings. Most small businesses have been unwilling to incur the cost and hassle associated with attempting to raise capital through public securities offerings. Businesses, both large and small, are discovering that additional capital raised through borrowings or offer-
ings of securities is expensive—if available at all. This situation has caused an increasing number of business persons to ask themselves the why of pumping large amounts of badly needed cash into funded retirement systems at a time, when the business badly needs that cash for survival or growth.

Since the effective federal income tax rates for small profitable corporations are relatively small, many small business persons are asking their advisors to explain the rationale for making deductible contributions to fund pension plans while desperately trying to raise capital at high costs.

Assume a corporation which has a $25,000 profit before contributing to a funded retirement plan. The federal corporate income tax on that $25,000 is only 15%. If that corporation badly needs a machine which costs $25,000, some simple arithmetic will demonstrate that the business is better off not putting the $25,000 into a funded pension plan. If the $25,000 is put into a funded pension plan, the “tax saving” to the corporation is only $3,750. The corporation is then faced with the prospect of attempting to borrow $25,000 to buy the machine. Assume the best scenario, i.e., the corporation is able to borrow the $25,000 and that the interest rate on the borrowing is 16%. That means that the annual interest charge on a pre-tax basis is $4,000. If the corporation continues to “umbrella its profits” by making deductible contributions to its funded pension plan in the future, the pre-tax and the after-tax costs of the borrowing are the same, i.e., $4,000. However, even assuming that in future years the corporation has an otherwise taxable income of $25,000, the deductibility of the interest still results in an after-tax interest cost of $3,400 per year.

Assume the corporation contributed the $25,000 to a funded pension plan, producing an annual return of 10%.

It is apparent that the corporation is much better off to not contribute the $25,000 to a funded pension plan. Rather the company should keep the money in the business. For a one time federal income tax cost of $3,750 (15% of $25,000) the corporation has spared itself a recurring annual after-tax interest cost of $3,400. This is not to mention the avoidance of the hassle of establishing and continuing a qualified funded retirement plan and the hassle of seeking and obtaining a loan to acquire the $25,000 which otherwise would have gone into the hands of unrelated entities in which the pension plan invested the money.

The hassle factor in connection with establishment, constant revision and maintenance of qualified retirements plans is a matter of great consequence—particularly to small businesses. Small businesses simply do not have the inhouse expertise necessary to establish and maintain qualified funded retirement plans. They must depend on outhouse experts. Larger businesses are usually able to afford inhouse staff to do much of the work connected with establishment and maintenance of a qualified funded pension plan. In any event, the administrative cost of maintaining a qualified retirement plan is (as a percentage of gross or net in-
come) higher for a small business than for a large business. This too is making more and more small business persons re-examine the feasibility of funded qualified retirement plans.

Even large businesses should be doing some arithmetic to determine whether it makes sense to fund management pensions while at the same time borrowing at high interest rates.

The enactment of the pension provisions of TEFRA will undoubtedly push more and more business persons to a reanalysis of their retirement plans.

THE EFFECTS OF TEFRA ON INCORPORATION ON PERSONAL SERVICE BUSINESSES

When it became obvious that TEFRA was going to include "parity" for the self-employed and partnerships, many commentators rushed in to print with predictions that this development would spell the end of incorporated personal service businesses.

A hasty review of the history of incorporation of personal service businesses—and particularly professional service businesses—will do much to explain why these commentators predicted the end of incorporation of personal service businesses. However, a more thorough analysis of that history will demonstrate why their predictions will not be borne out.

By tradition, by statute and by rules of court, the private practice of the so-called learned professions in the United States had for many years been conducted outside the corporate form. For decades, it was assumed throughout the United States that the private practice of medicine, dentistry, law and similar professions simply could not be done by a corporation. This concept was so ingrained that for years no one thought to challenge the basic premise.

The high personal income tax rates introduced during World War II, the fact that many fringe benefit programs (particularly funded retirement plans) were largely exempted from wage controls during World War II and the introduction of confiscatory excess profits taxes during the same period all combined to suddenly give a boost to the establishment of funded, qualified retirement plans during that period. The favorable rules with respect to qualified funded retirement plans were not available for self-employed proprietors or partners.

During World War II there was little agitation among self-employed professionals to achieve "parity" in the retirement plan area. This was in part based upon the fact that all citizens had their hands full with other problems during the war and pleading for lower taxes seemed to border on being unpatriotic.

Following World War II, individual income tax rates stayed at a relatively high level—as compared with pre-war periods. Generous corporate funded retirement plans continued to be popular and spread to more and more levels of business. Still, the tax advantages to individuals from establishment of such plans were limited to employees of corpora-
tions. More and more self-employed professionals began to complain about the unfairness of this situation.

The situation was particularly unfair to professionals in private practice who were not partners in institutional type partnerships. Large institutional partnerships began to establish unfunded nonqualified retirement programs for partners. At the same time, professionals who went to work for universities and other exempt organizations, for large business corporations, or for governments, were able to “get in on the action” in the qualified retirement plan area. Professionals engage in private practice as sole proprietors or as associates or partners in non-institutional partnerships ended up at the bottom of the totem pole in terms of ability to save for retirement.

Over the course of years, Congress only grudgingly gave small bits of partial parity starting with the first Keogh rules in 1962. The Keogh rules never caught up with the corporate plan rules and as a result, self-employed professionals felt themselves treated as second class citizens when it came to ability to save out of highly taxed income for eventual retirement—be that retirement voluntary or involuntary.

In the late 60’s the self-employed professionals got smart and decided to do an end run on the problem. Many started to think the unthinkable and say what to many seemed heresy, i.e., why shouldn’t professional practices be conducted in a corporate form?

When the traditionalists in the various professions got over their shock at hearing this rhetorical question, many among them began to think of reasons why professionals in private practice should not be incorporated. The reasons against incorporation ranged all the way from “we’ve never done it”, to “the patients [or the clients] wouldn’t like it”, to “if we incorporate, how would I identify my partner when introducing him at a cocktail party?”. Many detractors of incorporation of professionals theorized that by permitting a professional practice to incorporate, there would be a corporate veil interposed between the professional and the patient (or client) which would interfere with the personal nature of the relationship.

Despite these misgivings, the various professions convinced the legislatures and courts in all American jurisdictions to permit the practice of professions in corporate form, subject to certain special rules thought to be consistent with imposition of personal malpractice liability on those so engaged in a professional practice.

Suddenly, those in the federal government found that many members of the professions had despaired of achieving parity through Congressional action and had simply gotten their own parity by moving to the corporate side.

After over a decade of experience in the practice of professions through corporations, most of the predictions of terrible consequences put forth by the doomsayers have proven to have been unrealistic.

Throughout all of the movement just described, the disparity between

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3 P.L. 87-792, approved 10/10/62.
tax rules applicable to corporate and non-corporate pension plans seem to be the only matter in discussing whether to permit professionals to incorporate and whether, having achieved the ability to do so, a particular professional should to "go corporate". As a result, the impression was around that the only reason to practice a profession in a corporate form was to achieve parity with respect to tax rules on pension plans.

That helps to explain why so many commentators rushed to the judgment that once such parity was promised by TEFRA, no professional in private practice would have any further interest in incorporating.

Another explanation of the preoccupation with the pension plan aspects of incorporating a professional practice lies in the fact that establishment and maintenance of corporate pension plans are activities which give many persons an incentive to go out and sell the idea of incorporating. Accordingly, an unincorporated professional found himself courted by persons who were out to sell pension plans. This too added to the impression that achieving a better pension plan was the only reason for incorporating a professional practice.

The fact is that there are many tax and non-tax advantages to operating a professional practice in a corporate form which have nothing to do with qualified funded retirement plans. Later in this paper these various advantages will be discussed in more detail. Suffice it to say at this point that these other advantages were not of the type which lent themselves to being "sold". For example, there are many limited liability advantages to operating a professional practice in a corporate form. Most of us have frequently met persons who, with justifiable pride, identify themselves as being in the business of establishing and maintaining qualified pension plans. However, I can't remember a single instance of anyone being introduced in a formal or informal setting as being engaged in the business of selling the advantages of limited liability through incorporation. That simply isn't something which gets "sold".

Before blindly assuming that incorporation of personal service businesses is at an end due to TEFRA's promised pension parity, one should consider the remaining advantages and disadvantages of operating a personal service business in a corporate form.

THE NON-TAX ADVANTAGES

Ever since corporations became part of our legal fabric, the advantages of limited liability have been touted as among the most important reasons for utilizing the corporate form. Limited liability remains as a prominent (and in some cases, the only) reason for conducting a personal service business in a corporate form.

In practically all jurisdictions which permit the practice of a profession in a corporate form, personal liability for professional malpractice is preserved. However, in most jurisdictions, the extent of such personal
liability is much narrower than in the case of unincorporated professional practices. In unincorporated professional practices, a sole proprietor or partner is jointly and severally liable for all malpractice matters occurring within the proprietorship or partnership. Thus, any single partner in a three-hundred partner law firm maintaining offices in several American and foreign jurisdictions, can be held 100% liable for malpractice acts of employees or partners who he may never have met and with respect to whom he has no management responsibility. That is not the situation with respect to most incorporated practices. The professional corporation statutes in the United States generally provide that a professional operating in a corporate form remains 100% liable for his own malpractice acts and those which occur in the course of activities of persons operating under his control or supervision. That is a vastly different rule of liability. Even in a corporation owned by two professionals, it is not unusual for each of them to go his or her separate ways with no supervision from the other.

When it comes to liabilities not associated with malpractice, the corporate form offers even more clear cut advantages over an unincorporated form. In discussions about incorporating a professional practice, the mention of liabilities immediately conjures up only the image of professional malpractice liability. However, a little reflection will cause most persons to realize that limited liability for non-malpractice matters is a significant thing in most professional practices in this day and age. First, there are the common garden variety tort liabilities. For example, if in an unincorporated law firm one of the partners asks an employee to drive a car to the state capitol to file a paper and if that employee is involved in a serious automobile accident, every partner in that firm can be held jointly and severally liable for resulting damages. That is not so with respect to an incorporated law firm.

Detractors of the idea of professional incorporation tend to scoff at such examples and point out: “That’s the sort of thing one can get insurance against”. Insurance may or may not cover such liability depending on the amount of liability coverage maintained by the particular partner whose car is being used for the trip to the state capitol. Attorneys who deal in matters of these liabilities everyday can point out numerous horror stories of liabilities which simply aren’t covered by insurance.

Libel and slander type of liabilities are another example of situations where limited liability through the corporate form is meaningful and may someday prove to be significant.

Over the course of the last few years, leases for office space in most areas contain cost of living escalators for rent and pass throughs of increased utility and maintenance costs. A ten-year lease calling for $100,000 a year rent at the outset may at the end of ten years involve

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4 For a more detailed discussion of this, see 17 Business Organizations, EATON, Professional Corporations and Associations, § 3.02.
a rental liability many times that figure. If the lease is with a partnership, every partner is jointly and severally liable for the entire lease obligation which no one can quantify at the outset of the lease. Limited liability through use of a corporate form is meaningful with respect to such leases.

More and more professionals are discovering that capital is a "big deal" in their businesses. No longer is capital merely needed to finance accounts receivable and work in process—capital is important to acquire equipment without which the professional cannot hope to keep up with the demands of patients and clients. For lawyers in most areas of practice, word processing and data processing equipment is becoming a must. For those in the health care fields, more and more sophisticated and expensive equipment is needed to supply even minimum care. Often, such capital expenditures require substantial loans. Absent the use of a corporate form of practice, each and every partner in the practice is 100% liable for the principal and interest on the loan.

Twenty-five years ago it was probably unusual to find a professional partnership (other than some institutional type partnerships) which provided for continuing payments to disabled or retired partners or for payments to beneficiaries of deceased partners. The assumption was that every partner "took care of his personal responsibilities on his own". Now, it is commonplace for law and accounting partnership agreements to provide for payment to retired and disabled partners and to provide for some form of death benefit payment to survivors of a deceased partner. These arrangements are also becoming more common in the health care fields—particularly where large groups of professionals are involved.

These continuing payment obligations can be staggering in their implications. If the practice is conducted in a partnership form, each and every partner can be held 100% liable for making these promised payments following the withdrawal or death of a partner. Probably in the very large, institutional type law firms, this liability is not something that would keep a partner awake at night. In some partnerships there are limitations on such personal liabilities by agreement. However, in smaller firms this can be a substantial burden which may someday become a reality for the few remaining principals in the partnership. If the practice is incorporated, these unfunded deferred compensation liabilities can be limited to the assets of the entity as opposed to being potentially imposed on the personal assets of each principal.

The same observations are true with respect to obligations to purchase the equity interests of withdrawing principals.

These potential liabilities running the gamut from malpractice through deferred payments to principals are not imagined—they are real.

Another advantage of practicing a profession through a corporation is usually only known by those who have operated in the corporate form. That advantage lies in the potential for better management. Many professionals who have operated in a non-corporate form concede that
the lines of responsibility are often blurred. In many partnerships, it is unclear who has the responsibility for preparations of budgets, policing of financial matters and recording of partnership decisions. That is not to say that this is true in all partnerships. Many partnerships (particularly large ones) have excellent management controls. However, in small or medium size partnerships, the principals will often concede that these lines of responsibility are far from clear. These partnerships find that when they incorporate, the mere act of giving a corporate title to one of the former partners tends to fix responsibilities. Thus, when in the process of incorporating, one of the partners is given the title of Treasurer, he suddenly feels some compulsion to act like a treasurer, and prepare budgets and police compliance with them. The partner who is designated in the minute book as the Secretary, suddenly feels a responsibility to act like a secretary and to keep good records of decisions reached. It's true that these management responsibilities could be fixed without incorporating—it's simply that they usually are not, absent the compulsion of assigning titles in the process of incorporating.

The incorporation of a professional practice also tends to get away from the vagueness regarding ownership of "firm property" which seems to exist in connection with many partnerships. Again, this is a broad generalization and many people can point to exceptions. However, in the case of small to medium sized partnerships, the partners are usually so busy engaging in their daily activities on behalf of clients and patients, that they have little occasion to consider who owns particular tangible or intangible properties. The attorneys involved in the procedures incident to incorporating a practice tend to insist on clarity regarding ownership of assets. The value of this clarity is usually not realized until there is a business divorce at some later stage. At that point those concerned are high in their praise of the person who forced this clarity, even though they saw no point to it when it was first done.

Another of the traditional advantages of the corporate form for conducting business is to provide for continuity in the event of the death, retirement or withdrawal of a principal. That advantage is definitely present whether the business is the conducting of a profession or the manufacture and sale of goods.

Operating a professional practice in a corporate form also gives the business the advantage of being able to pick a natural fiscal year rather than being forced into a calendar year. Under existing federal tax laws, a partnership (and now a subchapter S corporation) is forced to adopt, in most cases, a calendar year, unless the principals are able to convince the Internal Revenue Service of the business necessity of some fiscal year other than a calendar year. In the case of a regular corporation, the corporation is free at the outset to pick any fiscal year.

Many professionals find that the use of a calendar year is inappropriate or inconvenient. December is a generally bad month to wind up

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8 I.R.C. § 706(b)(1).
9 I.R.C. § 1378, added by P.L. 97-354 approved 10/19/82.
the affairs of most personal service businesses. It is a month full of holidays, snowstorms, pressures from clients to get work done before the end of the client’s taxable year, or before the client takes off for warmer areas or for skiing. These pressures leave little time for the professional to devote himself to the decisions with respect to his own business which must be made before the end of his fiscal year. Thus, incorporating a professional practice enables professionals to pick fiscal years more consonant with their business needs.

THE REMAINING TAX ADVANTAGES OF OPERATING IN A CORPORATE FORM

Now that parity has presumably made establishment of qualified pension plans a neutral element in the decision to incorporate a professional practice, many persons tend to overlook, or pooh pooh, the remaining tax advantages of operating in a corporate form. These remaining tax advantages are significant. Item by item they may not be as significant as the qualified retirement plan factor, but separately and in the aggregate, they are worth considering.

First, there is the distinct advantage of being able to pay corporate taxes on retained earnings at rates which are usually well below the individual tax rates which would apply if the retained earnings had been distributed to the principals. It can be assumed that corporate income retained in the corporation would have been taxed at the individual principal’s highest marginal rates if the income had not been so accumulated. One should compare the assumed maximum individual federal income tax rates of 50% with the following federal tax rates on retained corporate earnings for 1983 and later:

<table>
<thead>
<tr>
<th>Income</th>
<th>Corporate Tax Rate</th>
</tr>
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<tbody>
<tr>
<td>0-$25,000</td>
<td>15%</td>
</tr>
<tr>
<td>$25-$50,000</td>
<td>18%</td>
</tr>
<tr>
<td>$50-$75,000</td>
<td>30%</td>
</tr>
<tr>
<td>$75-$100,000</td>
<td>40%</td>
</tr>
<tr>
<td>Over $100,000</td>
<td>46%</td>
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</tbody>
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Assume that an individual personal service business is unincorporated and produces $200,000 of net income. Assume further that the business is owned by a sole proprietor. The last $100,000 of personal service net income is subjected to a $50,000 individual federal income tax. If the practice is incorporated, the second $100,000 of personal service net income is subject to a federal corporate tax of only $25,750, if held back in the corporation.

In counselling the accumulation of corporate income, an advisor must always be aware of the possibility that the Internal Revenue Service
may assert a penalty tax on the grounds that the surplus was unreason-
ably accumulated in order to avoid surtax on the stockholders.\(^7\)

Even a specified personal service business is entitled to an accumula-
tion of $150,000 of surplus on a no questions asked basis.\(^8\) Once the
accumulated surplus passes $150,000, the accumulation of additional
surplus may be attacked. However, in that event most personal service
businesses can point to the need for accumulations of surplus for pur-
poses of paying off debts; purchasing expensive equipment; carrying
large work in process inventories and substantial accounts receivable;
financing the opening of branch offices; anticipating retirement payments
to principals and others; buying out equity interests of retiring or de-
ceased principals; and carrying disabled principals to the extent disability
insurance is either not available or too expensive.

Despite the so-called parity achieved in the pension area, there are a
number of other fringe benefit programs with respect to which principals
in an incorporated business enjoy a tax advantage over unincorporated
sole proprietors or partners. In terms of dollar volume, probably the
second most valuable tax-free fringe benefit program for most employees
is an insured or self-insured medical expense reimbursement plan. This
is second only to qualified retirement plan benefits in the dollar advan-
tages to employees.

The tax-free nature of disability insurance premiums paid by the em-
ployer is another important advantage not available to principals in un-
incorporated businesses.

More and more businesses of all sizes are turning to the establishment
of VEBAs\(^9\) as a way to fund to provide various fringe benefits. Such
plans must be for the benefit of employees, although a proprietor can
be covered if 90% of the beneficiaries are common law employees.\(^10\)

Although the advantage of tax-free provision of group term life in-
surance protection is becoming less and less important—it is significant
to the extent of coverage up to $50,000. A sole proprietor or partner
cannot enjoy even that limited advantage.

Perhaps no one of these tax-free benefit programs standing alone
could justify the cost and hassle associated with incorporating a pro-
fessional practice, but in the aggregate, and when combined with the
ability to accumulate income at low corporate rates, they usually furnish
ample dollar justification for incorporation. This is particularly so when
it is recognized that in today's climate, if a business person plans to
attract top people to furnish the personal services which are the inven-
tory of personal service businesses, that employer must be prepared to
furnish substantial fringe benefit programs for the employees. Thus, it
is not as if the choice lay between being unincorporated and not pro-
viding fringe benefit programs, or being incorporated and supplying
those benefits. Most personal service businesses find that to get top

\(^7\) I.R.C. § 531.
\(^8\) I.R.C. § 535(c)(2)(B).
\(^9\) Voluntary Employee's Beneficiary Associations under I.R.C. § 501(c)(9).
\(^10\) Treas. Reg. § 1.501(c)(9)2(a)(1).
employees they must provide these benefits for non-owners. Accordingly, staying unincorporated does not necessarily result in avoidance of the costs of providing these programs—it merely means barring the owners of the business from the tax advantages of participating in such programs.

Even in the qualified retirement plan area, TEFRA did not achieve complete parity.

TEFRA put limitations on the ability of participants in qualified plans (whether maintained by corporate or non-corporate employers) to borrow from the retirement plans. However, in the case of owner-employees in an unincorporated retirement plan, the prohibited transaction rules still apply to any loan from a qualified plan.

If, for any of a number of reasons, a qualified plan refunds to the employer excess funds, there is a vast difference between how such refunding effects the tax liabilities of incorporated businesses and the principals in unincorporated businesses. Assume that there is an actuarial surplus in a qualified retirement plan which must be returned to the employer entity. If the employer entity is a corporation, such paid back contributions will be picked up income but taxed at corporate rates whereas if the entity is unincorporated, those returned contributions will be picked up at the highest marginal tax rates of the sole proprietor or partners. Also, if the payback is to a corporation, there can be some judicious timing of compensation payments to principals to spread out the tax liabilities on the paid back amounts. Such planning possibilities do not exist in the case of a sole proprietor or partnership employer.

The last tax related advantage of incorporation may seem silly to persons who are sophisticated in financial and budgeting matters. But for those who deal with real life "out there where the rubber meets the road", it is a real thing. Many professionals who have become incorporated have told their advisors that one of the great advantages which they noted after incorporation was the avoidance of the estimated tax crunch by virtue of being put under the withholding system. I recognize that if the professionals involved had been "well organized financially" they would have been setting aside out of earned income enough to meet the quarterly estimated tax payments. However, many professionals are simply not that well organized. Accordingly, the budget discipline of regular withholding of income tax and social security taxes is a definite plus for many professionals.

THE DISADVANTAGES OF INCORPORATION

Even the most ardent missionary on behalf of operating professional and other personal service businesses in the corporate form must concede that there are some disadvantages. First, there are extra employment taxes associated with operating in a corporate form. Unemploy-

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12 §§ 406 and 408 of ERISA, (P.L. 93-406, approved 9/2/74).
ment taxes are generally inapplicable to earnings distributed to sole proprietors or partners. This seems to follow logically from the proposition that such proprietors and partners are not qualified to receive unemployment benefits. Once a practice is incorporated, the principals in the business find their wages subject to unemployment taxes. Generally, these are not big dollar amounts, but they are definitely an added cost attributed solely to incorporation. The irony is that in most professional practices, which are incorporated, the principals will never qualify to receive unemployment benefits.

The detractors of professional incorporation often state that the FICA taxes increase substantially as a result of incorporation. Arithmetic demonstrates that this isn't true on a net effect basis.

Assume that during the year 1982 a professional was operating as a sole proprietor and that he had net self-employment income of $100,000. Only the first $32,400 of such net income would be subject to the 9.35% self-employment tax resulting in a tax of $3,029. None of that self-employment tax is deductible by the sole proprietor in computing his regular income tax.

Assume that the same individual incorporated his practice and had the same net practice income, i.e., $100,000. The corporation would pay an employer's social security tax of 6.7% of $32,400, or $2,171. That employer's social security tax is in effect deductible by the principal since it is subtracted from his $100,000 net practice income, leaving $97,829 to be distributed as cash compensation—assuming no other deductions or fringe benefit payments on his behalf. The former sole proprietor (now a corporate employee) in addition pays $2,171 of employee social security tax, i.e., 6.7% of $32,400. Thus, in the incorporated status, the corporation and the principal in the business together have paid $4,342 in social security tax. However, the former sole proprietor has in effect been granted an income tax deduction for the $2,171 paid by the employer. Thus, the after-tax cost to the principal of the employer payment of social security tax is only $1,086 (50% of $2,171).

The former sole proprietor after incorporation has an after regular income tax cost for social security of $3,257 ($2,171 plus $1,086). This is only $228 more than the after income tax cost of paying self-employment tax. When one factors in state and local income taxes, the disparity either is reduced or completely disappears.\(^\text{13}\)

The costs of incorporating are a factor to be considered in making a decision whether to incorporate a personal service business. In general, the mere act of forming a corporation does not involve high fees. The incorporation of a business coupled with the installation of a qualified retirement plan can involve substantial costs. However, the bulk of these costs are going to be incurred simply because the establishment

\(^\text{13}\) For example, if state and local income taxes are 10% (after taking into account the federal income tax effect of such taxes), the after tax cost of paying employer and employee social security taxes is only $3039—only $10 more than the after tax cost of self employment tax.
of a qualified retirement plan, whether or not undertaken in the corporate form. Thus, if a personal service business plans to establish a qualified funded retirement plan, most of the costs will be involved in that part of the job, whether or not incorporation is involved. The added cost of incorporating is the tail, not the dog.

Those who urge against incorporating a personal service business frequently point out that there are substantial recurring costs involved in being incorporated. It is true that there may be some small additional state or local taxes imposed on corporate businesses which may not be borne by unincorporated businesses. However, when the after tax cost of this factor is computed it usually turns out to be insignificant in the whole scheme of things.

Much of the accounting work involved in connection with operation of an incorporated personal service business would have to be done whether or not the business was incorporated. The added accounting costs associated with the corporate form are usually de minimus. There are usually extra legal fees associated with annual maintenance of a corporation, simply because a lawyer is involved in preparing minutes, attending minutes, and the like. However, it is my observation that this extra cost is a very inexpensive form of “insurance” against tax audit troubles traceable solely to poor paper work. By and large, incorporated personal service businesses which have agreed to annual policing by lawyers and accountants have not experienced great difficulties in connection with tax audits. Many tax audit problems can be traced directly to poor corporate housekeeping. Those who have been exposed to regular handholding by accountants and lawyers generally have had good corporate housekeeping. Accordingly, the small extra cost associated with having business affairs monitored regularly by accountants and lawyers is well worth it, in terms of good tax audit results.

WHAT TO DO WITH EXISTING PERSONAL SERVICE CORPORATIONS

First—don’t panic. With the limited exception of personal service businesses caught under Code § 269A,14 most of the pension reform legislation in TEFRA is not applicable until 1984. Thus, there is time for reflection and a chance to see which way the wind is blowing in temporary and early regulations, rulings and other announcements by the government.

Many of the necessary regulations and rulings under TEFRA may not be issued in final form for four to five years, if the past is any guide in this area. Accordingly, the conservative approach to planning under TEFRA pension reform provisions is recommended. Pushing matters to the very edge is going to prove expensive in the long run. Many of those who push to the very edge are not able to do so quietly, but insist on publicizing their brilliance in the tax minimization game. Accordingly,

14 Added by TEFRA § 250(a), effective for years beginning after 12/31/82.
many of the gimmicky type of reactions to TEFRA are going to be called to the attention of the Treasury and Congress. This will result in "remedial" legislation or regulations.

Another reason for holding back from temptation to go to the very edge is that the rulings and regulations eventually issued may indicate that the caper carried the client beyond the edge. At that point there will first be the embarrassment of telling the client that he's over the edge, and next, telling him that he must anticipate the expense and hassle of pulling back to get within the regulations.

Code § 269A gives the Treasury very broad powers to allocate income, deductions, credits and other allowances in the case of personal service corporations formed or availed of to avoid or evade federal income tax by reducing income or securing certain benefits. It's most important to note that this section is only applicable if "substantially all of the services" of the corporation "are performed for (or on behalf of) 1 other corporation, partnership or other entity." Thus, the new section is not applicable to personal service businesses which are engaged in rendering services to a number of clients, patients or customers. One group of personal service corporations seems to stand directly in the line of fire under Code 269A. Those are incorporated partners in personal service partnerships.

§ 269A is effective for taxable years beginning after December 31, 1982. Accordingly, checking the applicability of § 269A and avoiding its fallout is a here and now matter which cannot be delayed.

The fact that parity between corporate and self-employed pension plans is not effective until 1984, whereas Code § 269A is effective in 1983, has posed a problem for incorporated personal service businesses which are potentially subject to § 269A. Even before TEFRA passed the Senate a question arose as to whether § 269A will be used in 1983 against a personal service corporation if the purpose of having the corporation is to get a better retirement plan than would be available in a non-corporate form during 1983.

During the Senate floor consideration of TEFRA, Senator Dole, the Chairman of the Finance Committee, made a statement indicating that if securing a better pension plan was the sole purpose of maintaining the corporation in 1983, that should not be used by the Treasury as a basis for applying § 269A in view of the fact that parity will be achieved one year later.15 In recent correspondence, Congressman Rostenkowski, the Chairman of the Ways and Means Committee, has indicated agreement with this statement by Senator Dole.

However, the positions of Senator Dole and Congressman Rostenkowski only address the matter of differences between pension plans—they do not give absolution to personal service corporations with respect to other tax advantages if securing such other advantages was the principal purpose of starting or maintaining the corporation.

Before rushing to disincorporate an incorporated partner, care should

15 Congressional Record, August 19, 1982 p. S 10903.
be exercised to make certain of the tax results which will flow to the stockholders of the disincorporated business and to the other partners in the partnership.

The realization of income at the corporate level on account of depreciation recapture and the extra tax possibly associated with investment credit recapture, should be thoroughly investigated before disincorporating a corporate partner. Also, if there is a disincorporation of a sufficient number of corporate partners in a particular partnership, the partnership’s taxable year may be prematurely terminated.\(^{16}\)

Before recommending disincorporation the advisor should also carefully study § 247 of TEFRA. This is not an amendment to the Internal Revenue Code, but was intended as a one shot relief provision for what the sponsors of the section assumed would be a wholesale rush by incorporated professionals to disincorporate. The relief provided by that section is closely limited. No one should assume that this provision grants general tax absolution for disincorporation of personal service businesses.

Assuming that a corporation does not run afoul of the § 269A provisions, I believe that most unincorporated personal service businesses will remain in corporate form. Many incorporated personal service businesses were put into corporate form in order to gain the advantages of a better retirement plan but now that the principals of such businesses have found the other tax and non-tax advantages of operating in corporate form, most will continue in corporate form.

This situation is neatly summed up in the title of a post World War I song, "How You Gonna Keep Em Down on the Farm After They've Seen Paree?" The principals in personal service business who have experienced the advantages of incorporated status will not likely abandon those advantages simply because pension benefits are roughly the same whether the business is incorporated or unincorporated.

For those personal service businesses not yet incorporated, there is no question that there will be a slowing of the trend towards operating in a corporate form. This is because there simply won't be the incentive for those who sell pension plans to urge incorporation as a necessary first step to achieve the best type of plan. However, for those who, through inquiry or otherwise, are advised about the advantages of operating in corporate form, the trend towards incorporation will continue.

CONCLUSION

The incorporation of personal service businesses is now acceptable conduct. Most of the advantages of operating in corporate form are still present. TEFRA may diminish the urge to incorporate a personal service business, but it will definitely not eliminate it.

\(^{16}\) I.R.C. § 708(b)(1)(B).