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## Legal Issues and Related Tax Issues

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## LEGAL ISSUES AND RELATED TAX ISSUES

MR. WILF:

This will be in the form of a free-wheeling, free swinging lecture on some of the most important aspects of the subject matter assigned to me and if I sound somewhat heretical it's because for many years I was not known as a staunch advocate of the concept of professional corporations. I still share that basic concept although in the past year I have succumbed to the wishes of clients and have started forming them with rapid ease and the problems that come up are really interesting so I have a different depth now than I had maybe a year ago as to what is involved.

The outline indicates that the first area is to be Business Reasons for Incorporating and Challenges by the Internal Revenue Service. In this connection I will give a free commercial to my good friend Berian Eaton who has a fine book, a multivolume book on Professional Corporations that comes from Matthew Bender. And Berian goes into great detail of all the reasons why you have to worry about such things as section 269 and 482 and one other area. I think Berian as a proponent of the Professional Corporation, overstates the "bug-a-boo's", or may be I as a "Johnny-come-lately" don't see it with the same depth that he does. However, I do not see any real problem in the so-called section 269 area (if you recall that's the section of the code which says in essence that if a corporation is formed or availed of for the principal purpose of tax avoidance then you lose certain benefits accruing from that form of doing business). And there have been some suggestions made from time to time that that would apply equally to a professional corporation. At one time one of the chief pension reviewers in the New York area, Samuel Alexander, had even written on the subject I believe, stating that he is relying on section 269 to disallow professional corporations even though the regulations were being challenged. To me it always seemed from prior experience working in the Western Hemisphere Trade Corporation and so-called Possessions Corporation areas that you are allowed certain statutory benefits if you comply with the statutory rules. And the ruling on the Western Hemisphere Trade Corporations has been well known for years and it's cited in Mr. Eaton's book; it has also been cited in a very important article in this area written by Martin Worthy who now is and, at the time the article appeared in the Journal of Taxation was, Chief Counsel to the Internal Revenue Service pointing out that that old revenue ruling (which was IT 3757) has been updated to permit you to take advantage of the Western Hemisphere Trade Corporation special deductions if you meet these statutory requirements. So here too, I believe that section 269 does not pose an impediment to the normal procedure in the incorporation of a professional practice, whether it's a solo practitioner or a multi-physician, dentist or lawyer practice. I guess there may be some type of an outlandish

case, which I can't really think of, where 269 might be so applied. The only case I can think of that could be theoretically applied will be gone into further detail by Professor Ferguson, that would be the *Roubik* case, which really went off in a different direction as far as its theory. But unless you have some kind of a horrible outlandish case I think you can safely put aside section 269. One of the cases which has been cited in this 269 syndrome is the *Smithback* case and that's the case of a dry wall construction man who incorporated with the avowed purpose of taking advantage of the section 105 provision dealing with reimbursement of employees for medical expenses under a medical reimbursement plan. And that was so stated and honestly stated by the taxpayer and his counsel and the court held that this was a principal purpose for the incorporation of the business. However the court did not say that that was the reason why the deduction was disallowed; section 269 was not even in issue there. The only thing the court did point out, properly so, was that Mr. Smithback was the only salaried employee, he had two hourly employees and one part-time hourly employee yet he was the only person covered by the plan. I think Mr. Dray will no doubt go into the *Smithback* and that type of purpose in more detail.

And now let us move from 269 into another area which I think is another "bug-a-boo," namely section 482 dealing with the reallocation of income among business entities. Now 482 has something more going for it from the Treasury and Government point of view, than section 269. But there are a few things in this area that I think should be gotten out of the way. One of the principal cases cited as caution in the section 482 area is the case of *Victor Borge*, who combined his Cornish Hen Poultry losses with his professional entertainment business income in one corporation and 482 was applied by the Commissioner and by the Tax Court and approved by the Court of Appeals of the 2nd Circuit by allocating income from the corporation to the performer, Mr. Borge. 482 was applied there in a very interesting way. The facts showed that the poultry operation, absent the infusion of money coming from the entertainment end of the corporation, would have been losing an average of about \$120,000 or \$130,000 a year during the years involved. The facts also showed that Mr. Borge's income over the same period of years was averaging approximately \$160,000 or \$170,000. And what he did in order to avoid the application of the "hobby loss" code provisions, upon very appropriate tax advice, was to incorporate his Cornish Hen business and also incorporate his entertainment business so anyone who wanted to have his services would have to contact and contract with the corporation, except Mr. Borge would always have to guarantee a performance by the corporation. What he had was income going into a corporation from his personal entertainment endeavors which were offsetting the losses from the Cornish Hen business. The government came along and said

482 applies: the income must be allocated between these entities; Mr. Borge as an entertainer is a separate entity from the corporation and its Hen activities. The court bought that theory. I think it's an application of the old saw of "hard cases make bad law," but I'm not sure if a bad law was made. I personally have the feeling that Mr. Borge's tax advisors came out on top on that one because under 482 the Commissioner only allocated \$75,000 per annum to Mr. Borge as reasonable allocation for services rendered, whereas the corporation was netting about \$160,000 to \$170,000 out of his personal services. In fact the Court of Appeals in its own opinion stated that they thought that the Commissioner's allowance was quite generous. But the Borge case is distant from the case of a professional corporation. The law in most states will permit a professional corporation to operate only the practice of the profession and maybe some income producing activities associated with it, but being in the Cornish Rock Hen business is not the same as owning the office building in which one may conduct a practice, or something of that type. So I think the Borge case has been overplayed. The best that can be said for it is a very faint straw in the wind; that if you do have another type of outlandish situation in which you are trying to offset professional income against some unrelated loss activity you will run into the same problem as Mr. Borge did.

The third category of cases about challenging the legal existence of a corporation which are more appropriate, are the *Roubik* type cases about which Mr. Ferguson will go into more detail. The point in that case is that it was not a section 269 proceeding, nor was it a section 482 challenge by the Commissioner; it was simply: "gentlemen, whom are you kidding?"

Now the one area which is not mentioned in the outline as to my scope of coverage, but I'll give just passing mention to it, is the employee status situation. There has been much written about the challenges particularly to the corporate status of the sole shareholder, the sole single practitioner, the dentist, the single doctor, (he has one secretary or nurse and he is the sole source of professional income). And many people have speculated and written that he is the low man on the totem pole as far as satisfying the corporate indicia. For many years I certainly agreed with that, particularly in Pennsylvania, when all we had was a so-called professional association statute. Under that statute it was questionable to begin with whether you had the corporate attributes satisfied. And if you had a one man corporation you were only exacerbating an already weak situation and I felt it was almost hopeless. The situation in Pennsylvania cleared up dramatically when the legislature passed in 1970, about a year and a half ago, a very strong "corporate" type statute which is just as good as any other corporate statute of any other state. And as I change my position on thinking about incorporating physicians or dentists, my thinking

also changes as to incorporating sole practitioners. Even though I started off with this inviewed prejudice that maybe they're in real trouble, I came out with the conclusion that they're probably better off in many respects than an association or a corporation that has several professional practitioners. I believe this is so particularly in the area of compensation (which Mr. Lurie will go into) because they don't have to worry so much about the corporate house cleaning (which Professor Ferguson will go into); I think they're on safer grounds as far as compensation is concerned since they are the sole source of personal service income. And I think they are the easiest case to deal with if you have a very strong, very fine corporate statute to work under.

Now onto the more difficult, more technical, more interesting aspects of my topic, and that is "What Assets Should be Transferred." Here there are no hard rules and this is the only rule to remember . . . that there are no hard rules. Let me start with the easiest case and work backwards. Many of you have formed, I'm sure, many more professional corporations than I, and in the process have been confronted with the statement by the eager physician that he has read in Medical Economics or has been told by his colleagues out on the 17th hole of the golf course that he can go out and buy himself an XKE now and have the corporation pay for it and there's no problem about it because there is an easy way of accounting for mileage, you know, you are now an employee and can account for mileage on the basis of 15 cents a mile, no accounting necessary and everything is just wonderful. Well, I have found in going over the half a dozen physicians I have incorporated, and the one lawyer, that I come up with different rules or different results regarding the automobile. And I think this is where the pragmatist has to meet the theorist. I found, for example, that in the case of one dentist, who has been audited every year for the last dozen years and he comes out with virtually no changes, but he gets audited regularly, that for the last several years whoever has been auditing has been following the predecessor auditor and would allow him a certain specific percentage of his automobile expense. And going over the facts of the situation, I would reach the conclusion that this method was a very highly satisfactory resolution of the question of what the automobile expense of the dentist was. So in his case to move his automobile that he uses from his personal ownership to the corporate ownership to me was kind of silly. He was already getting a substantial allowance for that automobile. On the other hand, his wife was an attorney. And where she was practicing, a less populous area, she was scurrying all around using her automobile. In her case it was definitely to her advantage to use the higher rate of reimbursement and nonaccountability standard than her husband's dental practice. So here we have a lady lawyer whose automobile we put into the corporation and her dentist husband, whose automobile we kept out of the

corporation. The reason being that the arithmetic showed that that would be best suited. You have an option. You don't have to transfer automobiles to a professional corporation. Nor do you have to transfer all your physical property. I emphasize the word physical because here begin other types of problems. Take the case for example, of a non-hospital based radiologist. I guess they have more highly priced equipment than any other type of physician, maybe \$100,000 or more. When you incorporate that type of radiologist should you transfer that equipment to his corporation? The chances are probably no. If he has someone else working with him, I think the chances are probably "no" even more so; but even if he is a solo practitioner, when you get to the area of reasonable compensation you are going to find out that there may have to be some kind of recognition given to the quantity, the capital invested in a corporation, as to how much an individual practitioner may be able to take out as reasonable compensation. So why put in this highly priced equipment. Also, if you do transfer the equipment you will probably be subject to depreciation recapture. As to the investment credit recapture rules, I must confess, I've not kept up with the most recent tax bill. They, like the old rules, do differ from the section 1250 depreciation recapture rules and in one sense they're more liberal. If new equipment is to be purchased you must consider which entity is going to buy that equipment, the physician in his individual capacity or his professional corporation. Because it may make a difference when you buy it individually and then transfer it later. Also, if in fact you keep the equipment out of the corporation, again I'm talking about the radiologist as a typical case, what you've done now is so-called "thinned out" the corporation. You can now lease that equipment to the corporation at a fair rental and there are standards to go by because radiological equipment can be leased. And the doctor can get a source of income from leasing the equipment to his own corporation, which is perfectly proper and reasonable. And also you avoid some complications on the reasonable compensation area. So the type of equipment is very important. And you have to work it out to see what your recapture problems are, if any, whether it's depreciation recapture or investment credit recapture. The type of transfer of property that causes the most trouble is accounts receivable. Now any professional practice, physicians, dentists, lawyers, what have you, are typically going to have a fair amount of unbilled time or if it has been billed, uncollected. What do you do about this? Well, the first thing that you will find out as you go through the arithmetic for those who haven't done it, that you probably need all those accounts receivable transferred if you're going to maximize the income in the professional corporation in order to maximize the amount that can be put aside in all these tax goodies that Mark Dray is going to talk to you about. The more money you have in a professional corporation, the more money you can put aside under

even standard rules relating to deferred compensation plans. So it's normally advantageous to transfer all of the receivables or substantial amount of receivables to the corporation. What about liabilities, for a moment? Well, I have found in the ones that I have done [i.e., incorporated], (again, all except one have been single practitioners) that liabilities do not amount to too much. But if you get a large group practice, medical or otherwise, you're liable to have substantial liabilities. What happens if you transfer these liabilities along with these assets to the corporation? Well the famous case here, of course, is the *Raich* case 46 T.C. 604. And what Mr. Raich's tax advisor failed to recognize there, namely that when you transfer accounts receivable from a cash basis taxpayer to his newly organized corporation, those accounts receivable, even though worth \$75,000 (as were the facts in the case), have a zero basis. Section 357 of the code provides that where you do have an otherwise tax free 351 incorporation of a partnership or a sole proprietorship, if the liabilities assumed or the liabilities to which the assets transferred are subject, exceed the adjusted basis, not the fair market value, but the adjusted basis of the assets transferred, there is an automatic realization of income (whether it's capital gain or not is another question), but it's automatic realization of income under section 357(c). And try as he could, Mr. Raich's second attorney (I presume the first one got fired) or accountant, was not able to convince the Tax Court to change the section 357(c) rule, nor should they have. So you have to be extremely careful of what you are transferring here, and to make sure you do not run afoul of that case.

Now there is an old case in the area of transfer of accounts payable, the debts incurred by the predecessor or sole proprietorship or partnership. You owe \$50,000 in outstanding bills for services rendered, for purchases, what have you. So you transfer the partnership's sole property, which is subject to a liability, to a corporation. Now we are talking about a cash basis transferor, because typically that is the case with the professional corporation. Obviously, if the bills are still outstanding the transferor has not paid them, and has not received a deduction for them. And if you transfer those liabilities to the corporation will the corporation receive a deduction? There is an old case called *Holdcroft*, I don't have the citation, but it's a case which always struck fear into those of us who read it and remembered it that the corporation just "ain't" going to get that deduction. It's just the cost of acquiring the assets, the business. There is no rationale. Yet, very happily, unless the policy has changed, Mr. Worthy, in that 1970 Journal of Taxation article I mentioned earlier (which was taken from a speech he gave in St. Louis earlier that year), stated that the Internal Revenue Service will give rulings, so-called closing agreements, dealing with the transfer of assets and the assumption of liabilities. Under those rulings the result will be that the transfer of the

accounts receivable will not result in income to the predecessor partnership or sole proprietor but will be taxed as income when received to the corporation and that the corporation will be able to deduct those liabilities which it assumed, which I think is a very helpful situation. In fact, really I think the legal precedent is contrary to that. There is legal precedent to the effect that the transfer of accounts receivable from a sole proprietorship or a partnership to a corporation will not result in the income being taxed under any theory to the transfer of an entire business (now let's not get involved to the transfer of little pieces of businesses), there are several cases to the effect that you are perfectly alright, the assignment of income theory will not apply, nor other types of theories. If you transfer only part of your business, that rule will not apply. So the authority is there, and I have always taken that position. Because the corporations I have done have never been involved in huge amounts of accounts receivable I would not go for a ruling. It would just delay the thing and result in unnecessary cost. However, if you are dealing with a huge amount of accounts receivable, like say incorporating a large law firm, I think you would be well advised to go for a ruling. But the *Holdcroft* case has always prevented my attempting to have the successor corporation attempt to deduct the expenses when paid. And again, fortunately, in the ones that I have done, and I guess most of the professional corporations you have done, the liabilities are not that great. So have them paid off before incorporating. Even there, there might be a slight distortion of income. If prior to incorporation you incur a lot of liabilities not in the normal course of your affairs, pay them off and get the deduction in your individual return. Then upon incorporation the normal expenses will not be incurred for several months. Thus the distortion of income and possible problems. This would be an area of concern. But simply paying the ordinary bills before you incorporate should create no problems. But if you start prepaying expenses, you're asking for trouble. And you'll probably get it. Now the tangible asset problem I think we have gone over. The accounts receivable problem we've touched upon. There are one or two more areas which are more difficult and require more consideration.

The most difficult area of all is where you do have an existing partnership. The existing partnership may have made arrangements with one or more deceased or retiring partners for the continuation of payments, for some specified period of time, to that retiring or deceased partner under section 736 of the Internal Revenue Code. For those who are familiar with that provision, it permits partnership payments to retiring or deceased partners and claim a deduction for those. And the retiring or deceased partner's estate will take into income as ordinary income those items. But this applies only to partnerships. There is nothing in the partnership provisions or in the carryover provisions of section 381 (the nearest analogy) which permits a corporation to

carry some of the prior type of expense items of a predecessor partnership. There isn't anything. So if you have a large legal partnership for example (and this is one of the hangups that have faced large partnerships) how do you get around the problem of section 736 payments, since it is obligated to make these payments to the estate of the deceased partner or retiring partner. You want your deduction, but if you incorporate the entire practice there is no continuing partnership to claim those deductions. So you say, well, that's very simple, we'll just split the partnership into two; incorporate some and run the partnership with some. Well, this is a 482 problem, you see. That's a real problem for the first time. The most ingenious method I heard about solving this problem was from one of the large west coast law firms and they were going to have some very fancy arrangement. I think it might even work, where the law partnership would continue, and in a sense would grant a license to the corporation to use the name of the partnership (the members who gave the name have long since been dead so there is a lot of good will attached to the name) and the partnership would lease to the corporation the right to use the name. The partnership would get the licensing fees and keep making the 736 payments and the partnership gets the deduction. It's a very interesting theory and they might actually do it unless the law changes and then they may not be required to do that.

The last problem within my time allotment (about another minute) is beware, be cautious, stay away from, plan, do something about the partnership which is on a fiscal year. There are many law partnerships (the bigger ones are like this or it could be smaller ones as well), which are operating on the fiscal year basis. If you have a fiscal year partnership you have the "stack up of income" problem. Now fortunately, the Tax Reform Act of 1969 provides new rules for income averaging which are exceptionally helpful. I can vouch for that from my personal computations because now you can average at 120% of averaging income, instead of 133%. The problem remains, what do you do about it, how do you phase this out. Do you use income averaging or do you have to put your people in tax shelters. Can you put the corporation on a different fiscal year than the individuals, which is probably the best idea. So you can play a little bit, depending upon your situation, between the income going to the practitioner, particularly during the first year, and postponing some of the income during the latter part of the corporation's first year. You don't want to leave the corporation with a lot of income either. For example, between the normal federal rate of 48% plus the Pennsylvania corporate tax brings you up to 60%. Well, beginning in 1972, as we know, your maximum rate on earnings is only 50%. So certainly you don't want to leave any sizable amount of income at the corporate level. So if you do put your corporation on the fiscal year you want to pull most of the income out before the end of the fiscal year so you can play with your different years of your calendar year owners.