1971

Observance of Indicia of Corporate Characteristics Liquidation Problems

M. Carr Ferguson Jr.

OBSERVANCE OF INDICIA OF CORPORATE CHARACTERISTICS

PROFESSOR FERGUSON:

I find that I'm one year behind Mr. Wilf in my acceptance of professional corporations. I believe many New York lawyers are just beginning to respect this form of practice and to recommend them to other professionals. Very few have yet incorporated themselves. Perhaps, when we find that the most experienced incorporators of professionals are practicing in places like Florida, Texas and California, we should question M. Menken's old saw that the farther west he got the more he realized that the wise men must have come from the east!

There are, I believe, signs that professional corporations are beginning to be accepted in my part of the country. One of the big helps of course, was the Martin Worthy article which appeared in last February's Journal of Taxation. At the time, the Department of Justice had cases pending on the question of whether or not the transfer to a personal service corporation of payables and receivables by cash basis individuals constituted a taxable event. The article seems to concede this point, and the government withdrew defense of those cases. As Mervin Wilf says, I think that the conclusion reached by Mr. Worthy, that contrary to most of the decided cases, the transfer should not be subjected to taxation, was a correct one.

I should like to consider with you this morning, the question of "corporateness" of a professional corporation. What has to be done, in other words, to make sure that our client, once converted from a partnership or perhaps a solo practice into a corporation form of practice, is truly a corporation for federal tax purposes. In this connection, I should like to consider the steps to be taken to assure that the income from the practice will be taxed to the corporation, rather than to the individual under one or more of the theories mentioned by Mervin Wilf. Second, I hope to discuss in the time remaining really the more interesting aspect of my assignment area: What happens when the professional leaves his corporation practice?

First, I'd like to look with you for a moment at the question of what a professional corporation really is from a point of view of the Tax law. The *Roubik* case, decided by the Tax Court two years ago, involved a group of physicians practicing in various clinics and hospitals in their state. They decided they would form a corporation, and indeed all of the bookkeeping, the charter, the opening minutes, the bank account and so forth were duly created by their advisor. Unfortunately, this was not only the first but virtually the last steps taken by the physicians as corporate employees. In fact, they did just what they'd been doing every day of their professional lives. They went to their respective hospitals, continued their practice individually, absorbed their own individual expenses. True, they passed the income through a corporate bank account back into their individual accounts, but there was no operation as a group. There was no integrated practice by this corporation. The corporation owned virtually nothing, and indeed their contracts with their various hospitals were not even disturbed. The Tax Court, in a reviewed opinion, finally examining the issue of the "corporateness" of professional corporations after the many, many decisions in the district courts around the country sustained the tax corporateness of a professional corporation as a general proposition. But the Court went on to conclude that the purported professional organization before it had the two dimensional paper quality of a corporation, but was never operated as a corporation. The tax law continues to tax earned income to the person who earned it and in this case the income was earned by the four individual practitioners, not by their corporation.

The Tax Court in *Roubik* spent very little time with the traditional Morrissey criteria and the regulations under section 7701, as to limited liability, centralized management, continuity of corporate existence and ready transferability of shares. Under the regulations, you recall, if a majority of those four tests (I guess that means 3) were met, we then had something which was a corporation for tax purposes. This was regarded as the teaching of the *Morrissey* case, and I think we must admit, on analysis, that a professional corporation really has a bit of trouble with every one of those criteria. Limited liability? It's a special kind of limited liability, isn't it? State law regulates the extent to which professionals, licensed under their state, may limit their liability. It's not the same as a Buick agency. The professional must stand for his own advice, his own practice or malpractice and that of associates and colleagues working under his supervision. Centralized management? Perhaps. This gets to be rather fiction in a small corporation, and once again you have a question of ethics in many professional corporations, to what extent may a professional corporation's board of directors control the professional conduct of its members? Again I suppose we have continuity of existence but again there are questions about it that are peculiar to the professional practice and the personal relationship between patient and his professional. Finally, ready transferability of shares? Limited again, under professional corporation statutes and professional association statutes. Shares may be assigned to other qualified professionals, but not to others. The professional shareholders and their corporation further restrict transferability. Anyway, these four criteria are not really attacked in the *Roubik* case. In fact the Service has told us in published rulings that they accept qualification under most state professional corporation and association statutes as meeting the 7701 definition of a corporation.

Once established, there must be conduct of the practice through the corporation, which means, that the corporation must have a board of directors which is not just a paper tiger. It must meet. It must make decisions. Obviously, if there are people on the board of directors of a medical practice corporation who are not members of the profession, the board of directors can not influence the practice of medicine or the professional ministration of the physicians who are employees of this corporation, but it can take a good many steps in making decisions on how the firm is to be administered, how the business of the firm is to be conducted, in a non-professional, business way. Not only must there be a real board of directors, but there must be a relationship—foreign to traditional notions of personal responsibility of an attending professional—between the corporation and the patient or client. What I mean by this is that billing must be done by the corporation not by the individual partners. Fees must be received by the corporation, not the partners. Rates must be set by the corporation, not the former partners. And the decision as to which professional will perform the services to be rendered, must be a decision made by the corporation as the party contracting with the client (patient), not the individual partner. All of this may come as a shock, even dismay to the firm which has been long established and whose senior partner has been making these decisions himself, and who had understood incorporating merely involved centralization of management, which he had understood has been the case all along. But he must now realize that he has become an employee himself, along with his colleagues. And I believe that this can best be assured by a continuing relationship between the attorney who incorporated that firm, and the corporation to make sure that the corporation does carry on, not just the two-dimensional paper indicia of a corporation but the three dimensional business of a corporation with respect to its professional clients or patients. It helps, of course, if the corporation can have title to some property, if it can own something, if there can be a tangible something that you can point to besides the corporate name, as being property held by a corporation rather than an individual. I share, however, the views expressed by Mervin Wilf, that for a good many reasons it is best to keep the corporation's financial avoirdupois down along with the waistline of the middle aged partner.

Keeping a light, thin, trim corporation is a very healthy thing to do. For a number of reasons. Some of them have been mentioned already by Mervin Wilf. But I would like now to show you the advantages of the slim line when it comes to getting out. One of the first things a fire marshal will tell us to do in entering a room like this is to look out for the exits. One of the things we would counsel a lobster to do on seeing some bait in a box is to notice how he is going to get out after enjoying his meal. And certainly one of the things we should advise our clients seeking to get into this corporation and enjoy the goodies of qualified plans, a retirement which would have pleased

Croesus and so forth, is the problem of getting out of that corporation. In considering this, we ought to remember that while of course lawyers, as stable, conservative, sensible types tend to stay in their partnerships through their professional career (I'm leaving Mr. Wilf out of this, obviously he doesn't fit the mold) many physicians, at least, do not. Physicians' earning curves, starting at zero during their cloistered 20's and early 30's, through their residency, suddenly shoot up like a Roman Candle in their mid-thirties and forties. Their first association, which may seem desirable for a year or two, may suddenly pale as even greener pastures appear. Physicians, then, change their associations. And when we find that the primary benefits of incorporation are to be enjoyed not today or tomorrow but when they are 65 (and entertaining thoughts of partial retirement at least), we may find that by the time the physician is five years older, divorced, and practicing in a different city that continued affiliation with his first corporation is not only undesirable but a nuisance. How does he conclude the relationship without prejudicing his deferred benefits? Obviously, the key lesson here is to plan ahead. Our real concern here may be for the shifting of interests as older, heavier endowed members of the firm give up part of their interests to newer members and individual professionals retire out of a corporation that will continue its separate existence, but we must also consider premature complete severance of affiliation.

Let's consider these separately. First suppose we have the happily, evolving professional corporation, bringing in junior shareholders. There are two ways this can be done. First, the junior shareholder can be persuaded to buy new shares in the professional corporation, the corporation may, under its charter, issue such shares. Or the junior shareholder can buy some of the shares of the other participants in the corporation. The first of these alternatives injects new money into the corporation which may or may not be desirable. If my preference for a slim corporation balance sheet is correct, then it is probably not desirable. I would join, for example, in the recommendation to Mr. Wilf's radiologist that they retain their equipment out of corporate solution if they can and lease it to the corporation. What are we going to do with the money then? If we have a firm which has heavy overhead expenses, has a number of common law employees, cash is always helpful. But presumably cash is being generated at a heavy rate by the earnings of the corporation and are therefore not really needed. The corporation isn't in the business of generating capital through the selling of shares and it is probably undesirable to require the junior shareholders to inflate corporate capital by purchasing shares. Rather, it is cheaper for them to buy shares of the other partners. This may require recapitalization where fractional shares can not be issued, but this should be the lesser evil. The holders' purchase money, nondeductible in any case, would thus go directly to the seniors in return for their stock, providing them an opportunity to recover part of their initial investment in the firm, perhaps to have a small capital gain.

Again, however, it seems generally preferable not to make the occasion of shifts in equity interests much more financially significant than it is in a partnership. The question raised, of course, is how we fund the sale of stock to the remaining partners? The life insurance industry has a number of answers to this, if he dies. I think the best answer is to keep the share values low. This is accomplished primarily by distributing the net earnings each year to the shareholders beyond the compensation deductible to the corporation. While it is possible to pay salaries and use bonuses to achieve a mathematical perfection in eliminating all corporate earnings each year, it seems to me very doubtful if this practice would impress an auditing agent as reasonable compensation. Particularly if, as Mr. Wilf has suggested, there is significant good will in the corporation. The *McCandless*, *Norcal Adjusters* and other decisions last year suggest there must be some fair return to the shareholders in the form of a dividend and only what's left may qualify as reasonable compensation. Perhaps this seems a backward way of finding out what's reasonable compensation, but it is one which the courts seem to be embracing. In the smaller professional corporation, the tax on the dividends will be at the 22% rate, and this may not be too steep a tariff to pay for the benefits of incorporating. If the corporation is to be financially slim, the problems of retirement, I think, are properly left to deferred compensation techniques and the qualified plan rather than having an expensive capital interest to be bought out either by the corporation or the other shareholder.

A corollary to this, I believe, is the conclusion that the professional corporation, unlike corporations with a heavy capital commitment such as a mercantile corporation or a manufacturing company, is frequently a poor vehicle for using section 303 as a means of permitting an estate to convert significant corporate capital to cash. If the corporation is properly structured, there will not be a significant amount of corporate capital to be redeemed out. Putting it more directly, and putting it maybe in a way we are accustomed to thinking in professional partnerships, the professional corporation normally should be planned in a way to permit so-called section 736(a) payments which are deductible to the corporation and treated as ordinary income to the retiring partner, who is now going to be in a lower bracket after retirement anyway, or to his estate as income in respect of a decedent, rather than section 736(b) payments which would be a now deductible acquisition of a capital interest and tax free to the retiring partner or estate or capital gain. While the deduction may not be so valuable in terms of corporate rates, it will serve to reduce the amount of compensation which otherwise will have to be filtered out to the other partners. Further, at least its threatened repeal or amendment, section 2039 may well serve to insulate payments from a qualified plan from the estate tax on a deceased shareholder's estate, thus providing further inducement to follow this patterrn of retirement planning rather than a heavily funded redemption.

Now one last word before we break. There are, as Mr. Wilf put it a while ago, a number of "bug bears," a number of bases for attack on the professional corporation, but which normally do not withstand analysis. Some of these have to do with corporate liquidation. One theory runs that since the corporate assets at time of liquidation will be mostly unrealized receivables, the corporation is a collapsible corporation, which is to say that the distributions or the sale of stock or redemption of stock will generate ordinary income. As I have indicated, if the corporation is kept properly slim, that shouldn't make too much difference. But is it really a collapsible corporation? It is true that the collapsible corporation statute is a creature of several cases involving incorporated talents such as the celebrated *Pat O'Brien* decision some twenty years ago, but I believe that the kind of scheme for a short life corporation, which is at the heart of the collapsible corporation concept, just isn't present in the professional corporation. Normally, a professional corporation, in liquidation or transfer of interest, should have a very strong defense against collapsible corporation treatment under 341(b) on the grounds that the corporation is not formed or availed of primarily to liquidate or sell stock, or to engage in some other reprehensive behavior prior to realizing a substantial part of income at the corporate level.

The other "bug bears" alluded to by Mr. Wilf key around one idea. And that is that there will be an indigestible asset in this corporation which at time of liquidation is going to cause problems: good will. As long as the firm is practiced in partnership form, the existence of actual good will not recorded on the corporate books is unimportant, but once it goes into the corporation when distributed back out its value may be taxable under section 331. Even if the one-month liquidation, under section 333 is used, the good will is an asset which will attract part of the basis away from other assets. So you are losing some of the basis and now have back in the hands of the individual proprietors good will which is like purchased good will: nondepreciable, and, in many professions, not transferable. While I have heard of schemes employed by which the former partners retain the firm's name and lease it to their new corporation to mitigate this problem, among other reasons, I am skeptical. It seems to me that if the corporation is kept on a restricted diet of contributed and retained assets, the awkwardness of an ultimate section 333 liquidation are really rather unimportant, because the stock should not have a substantial amount of basis.