Professional Associations and Corporations: Tax Considerations

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NOTES

PROFESSIONAL ASSOCIATIONS AND CORPORATIONS:
TAX CONSIDERATIONS

INTRODUCTION

For some time, professionals have sought corporate status in order to gain tax advantages. Other reasons, such as possible limited personal liability may have helped promote the idea. States have often cooperated in helping them to obtain corporate recognition for federal income tax purposes, but have stopped short of relinquishing many common law attributes of professionals, such as unlimited personal liability. Until recently, the Internal Revenue Service took the position that professional organizations more closely resembled partnerships than corporations. After several years of litigation and legislation, the Service no longer objects to professional organizations which have many of the common law characteristics of a partnership if they qualify for taxation as corporations.

Federal income taxes are generally the most important consideration in determining whether to adopt a particular form of business organization. The purpose of this discussion is to explore the federal income tax advantages and disadvantages of the professional association. Particular attention will be given to tax provisions affecting common law employees, such as pension and profit-sharing plans and health and accident plans, which afford the most important advantages of professional incorporation. These will be examined with a view toward maximization of benefits for the "owner-employees."

HISTORICAL DEVELOPMENT¹

For purposes of income taxation, federal laws distinguish individuals

from corporations, with quite different rates applying to each.\(^2\) Partners are taxed as individuals, but the partnership itself is not taxed.\(^3\) Under certain circumstances, a corporation can elect to be treated as a partnership.\(^4\)

Organizations of doctors, engineers, accountants, attorneys, and other professionals, which have traditionally been treated as partnerships, have attempted in recent years to be treated as corporations. These attempts have been facilitated by the lack of statutory precision in defining terms. Under section 7701 (a) of the Internal Revenue Code of 1954 (hereinafter referred to as the Code):

(2) The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.

(3) The term “corporation” includes associations, joint-stock companies, and insurance companies.

Since such words as “trust” and “associations” are not defined in the Code; traditional attributes have been examined and the “usual” tests have been applied to determine whether a borderline organization more closely resembled a corporation or a partnership.\(^5\) The first important case deciding whether a professional association or corporation was a corporation for tax purposes was United States v. Kintner.\(^6\) The Court held that an unincorporated doctors’ association should be treated as a

\(^2\) INT. REV. CODE of 1954, §§ 1, 11.

\(^3\) Id. § 701.

\(^4\) Id. §§ 1371-1378. This is commonly known as a Subchapter S election. See text, infra, for further discussion.

\(^5\) This “resemblance doctrine” originated in Morrissey v. Commissioner, 296 U.S. 344 (1935). See also Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936). Morrissey and Pelton involved the question of treating a “trust” as a corporation. The definition of “corporation” has changed little since 1918 (as enacted by the Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057, 1058) and “partnership,” little since 1932 when it was first enacted (Revenue Act of 1932, ch. 209, § 1111(a)(3), 47 Stat. 169, 289). See generally Eaton, supra note 1.

\(^6\) 216 F.2d 418 (9th Cir. 1954).
corporation for the purpose of tax treatment of certain items although it lacked substantial attributes of a corporation.\(^7\) Other cases\(^8\) and the revenue rulings\(^9\) pertaining to professional organizations indicated that the determination generally would be based on federal standards and that state law dictating that professionals could not incorporate would have only secondary effect.

In 1960, the Commissioner issued the original "Kintner Regulations" defining an association:

The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. . . . These characteristics are: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. . . .\(^{10}\)

The regulations did not require that all these characteristics exist, but generally only a majority not common to the two forms of organizations in question.\(^{11}\) If an organization satisfied the requirements, it might still fail to qualify where the terms of the organization agreement were not consonant with the Uniform Partnership Act, Limited Partnership Act, or other controlling state statute corresponding to these acts.\(^{12}\) This latter requirement placed totally new emphasis on state statutes.

Most states reacted to the Kintner Regulations by enacting statutes permitting professionals to form "corporations" which meet the federal income tax requirements, but which retain non-corporate characteristics, such as unlimited personal liability. Other states enacted statutes permitting "professional associations" with enough corporate attributes to qualify for corporate treatment under federal tax laws.\(^{13}\) Thus, pro-

\(^7\) Accord, Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959). This case was decided after Rev. Rul. 56-23, 1956-1 Cum. Bull. 598, which expressly rejected the Kintner holding and stated that an unincorporated association of doctors was not an association taxable as a corporation.

\(^8\) United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); Galt v. United States, 175 F. Supp. 360 (N.D. Tex. 1959).


\(^11\) Id. § 301.7701-2(a) (3) (1960).

\(^12\) Id. § 301.7701-2 (1960).

\(^13\) At the time of this writing forty-seven states have enacted such legislation in one
professionals are able to form qualifying organizations, not in derogation of state laws, but, indeed, pursuant to them.\footnote{14}

In 1965 the Commissioner amended the Kintner Regulations by way of additions which had been under consideration since 1963.\footnote{16} First, he made it clear that state classification, as such, is not determinative. The regulation stated that “the labels applied by local law to organizations ... are in and of themselves of no importance in the classification of such organizations for the purpose of taxation under the Internal Revenue Code.”\footnote{16} More importantly, a new provision specified the treatment to be accorded professional service organizations.\footnote{17} It declared that they would be treated as corporations only if they possess the requisite corporate characteristics. Then, it demonstrated how difficult it would be for such an organization to ever meet the requirements. In short, it made it practically impossible for a professional service organization to be treated as a corporation for federal income tax purposes.\footnote{18}

Three United States courts of appeals,\footnote{19} and several district courts\footnote{20} have held these 1965 changes to be invalid. \textit{United States v. Empey}\footnote{21} held primarily that the Service could not change the long-standing practice, unaltered by Congress, of treating state “corporations,” professional or not, as corporations for federal income tax purposes. The court said that the 1965 amendments are inconsistent with the statutes, and “amount to an attempt to legislate.” In \textit{O'Neill v. United States},\footnote{22} the court said that a “corporation” under state law must be a corporation under federal form or another. \textit{S. P-H 1970 Fed. Taxes,} \textit{¶ 41,608}. Some states have limited such organizations to certain professions while others have all-inclusive statutes. The statutes vary as to the requisite number of participants, most requiring three or more.

\begin{itemize}
\item \textit{Foreman v. United States}, 232 F. Supp. 134 (S.D. Fla. 1964) demonstrated that professionals so organized could still qualify for corporate treatment. The case arose prior to Florida’s professional service corporation law. Since the precise issue was not mentioned, the association involved must not have violated the terms of then effective Florida law.
\item Treas. Reg. § 301.7701-1(c) (1965).
\item \textit{Id.} § 301.7701-2(h) (1965).
\item \textit{Kurzner v. United States}, 413 F.2d 97 (5th Cir. 1969); \textit{O'Neill v. United States}, 410 F.2d 888 (6th Cir. 1969); \textit{United States v. Empey}, 406 F.2d 157 (10th Cir. 1969).
\item 406 F.2d 157 (10th Cir. 1969).
\item 410 F.2d 888 (6th Cir. 1969).
\end{itemize}
eral income tax law and held the 1965 regulations invalid. Kurzner v. United States\textsuperscript{23} is in accord with Empey and O'Neill, although it emphasized that state labels, as such, would not control. "Corporations" were involved in each case, but the result should be the same where "associations" are involved since the statutory definition of corporations includes "associations." \textsuperscript{24} In fact, the courts relied on this language to show that the Service had unduly limited the statute and that some meaning must be given to "associations."

On August 8, 1969, the Service announced that it was generally conceding the issue and that organizations complying with state professional association acts would be treated as corporations for tax purposes.\textsuperscript{25} Thus, the test presently applicable is again whether an organization closely resembles a corporation under "usual" tests, and most state statutes present no obstacles to meeting these tests. It appears that compliance with state statutes will normally produce the desired corporate treatment.\textsuperscript{26}

\section*{Tax Considerations\textsuperscript{27}}

\subsection*{Corporate Taxation Generally}

It is elementary that Code section 11 imposes an income tax of 22 per cent on the first \$25,000 of corporate income and 48 per cent on the excess over that amount.\textsuperscript{28} Of course, that income is not usually subject to another tax unless it is subsequently distributed as a dividend. To be taxed as a corporation would work to the advantage of most professionals, assuming they are in a high individual income tax bracket; it would mean that up to \$25,000 might be sheltered in the corporation each year at the lower corporate tax rate (22 per cent) for future expansions, acquisitions, or other business needs.

\begin{itemize}
\item \textsuperscript{23} 413 F.2d 97 (5th Cir. 1969).
\item \textsuperscript{24} Int. Rev. Code of 1954, § 7701(a)(3).
\item \textsuperscript{25} T.I.R. 1019 (Aug. 8, 1969), 6 P.H. 1969 Fed. Taxes ¶ 55-334. The release said that the Service would not apply for certiorari in the circuit court cases or press appeals in the district court cases.
\item \textsuperscript{26} The state statutes must do more than merely change the name of a partnership to "association" or "corporation," but this they have done so far.
\item \textsuperscript{27} See generally Anderson, \textit{supra} note 1; Boughner, \textit{Mechanics of Organizing a Law Firm as an Association}, 57 Ill. Bar J. 800 (1969); Eaton, \textit{supra} note 1; Harl, \textit{Selected Aspects of Employee Status in Small Corporations}, 13 Kans. L. Rev. 23 (1964); Horsley, \textit{supra} note 1; Overbeck, \textit{supra} note 1; Zirkle, \textit{supra} note 1; Prentice-Hall, \textit{Thinking About Forming a Professional Corporation}, 1 P-H Tax Ideas ¶ 11,016 (1969); Institute for Business Planning, \textit{supra} note 1; Comment, \textit{supra} note 1.
\item \textsuperscript{28} Code section 51 currently adds a 5 per cent surcharge.
\end{itemize}
Two dangers associated with retained earnings should be noted. First, the incorporator should be aware of the possible imposition of a prohibitive accumulated earnings tax on earnings not retained for reasonable business needs. The tax imposed by Code sections 541-547 on undistributed personal holding company income must also be carefully avoided. Most professional corporations will have no difficulty with this as long as no individual owns 25 per cent or more of the outstanding stock or no such individual's services are specifically contracted for.

Being subject to corporate taxation causes some additional dangers. One is the risk that salaries, if paid in proportion to stock holdings, will be treated as dividends, and the deduction disallowed. There is the always present danger that travel and entertainment expenses will be disallowed. The disallowance of salary, travel and entertainment, or other expenses of a corporation is more significant than the same disallowance of partnership expenses. The disallowed corporate expenses are automatically subject to double taxation (no deduction to the corporation, but taxable to the recipient).

For most smaller corporations Subchapter S offers an expeditious device for eliminating these tax dangers by permitting the corporation to elect to be exempt from federal tax. If the election is made, taxable income of the corporation is passed through directly to the shareholders in proportion to ownership, whether or not actually distributed. Losses, too, are allocated among the shareholders.

Subchapter S thus offers a method whereby an enterprise may retain important tax attributes of partnership, while the “partners” are treated as employees for some purposes. Of course, the tax shelter is lost along with the dangerous aspects of corporate taxation. Subchapter S election should be considered in the following circumstances:

1. Where . . . the corporation will have taxable income and where because of the tax rates applicable to the shareholders the tax burden will be lower if the income is taxed directly to the shareholders rather than to the corporation [that is, where the corporate tax shelter is not in fact a shelter];

30. Id. § 543 (a) (5).
33. Id. § 1373.
34. Id. § 1374.
35. See Treas. Reg. § 1.1372-1 (c) (1968).
2. Where the intention is to pay out substantially all of the corporation's income to the shareholders but it is unlikely that this can be done entirely in the form of deductible payments. . .;
3. Where it is anticipated that the corporation will sustain losses in its early years which can be of use to the shareholders. . . .

Two problems of Subchapter S must be stressed: obtaining qualification and retaining qualification. A corporation may not make an election unless it is a domestic corporation which is not part of an affiliated group, has ten or less shareholders who are individuals and are not non-resident aliens, and has only one class of stock. Once the corporation is organized it must remain qualified. A valid election will be terminated if stock is transferred to a new stockholder who does not consent to, or qualify for, the election or the corporation ceases to meet the original requirements.

Provisions in the Tax Reform Act of 1969, signed into law by the President on December 30, 1969 mean that Subchapter S will not be a viable alternative for many corporations because the benefits of corporate type pension and profit-sharing plans will no longer be available to the "shareholder-employees" of such corporations.

The professional organization has another means of avoiding the disadvantages of corporate taxation which is not available to most corporations. Since most of the professional corporation's gross income is from personal services, nearly all of it can be paid out as salaries, without being considered unreasonable compensation, and can be deducted. Of course, there is no corporate tax on the amount of salaries properly deducted as a business expense. The accumulated earnings and

38. Id. § 1372(e).
40. See text, infra, for further discussion of this point.
41. The Code allows only a "reasonable" deduction for salaries or other compensation for personal services actually rendered. (Int. Rev. Code of 1954, § 162(a)(1)). The commissioner may inquire into reasonableness of compensation (Treas. Reg. § 1.162-8 (1958) ) and compensation in proportion to stock interest is particularly suspect (Treas. Reg. § 1.162-7(b)(1) (1958)).
42. Int. Rev. Code of 1954, § 162; Treas. Reg. § 1.162-7 (1958); 4A J. Mertens, supra note 31, § 25.68 at 276-280. As noted, such salaries should not be proportional to stock ownership or they might still be disallowed.
personal holding company taxes are imposed only on net income retained by the corporation.

There are a number of minor items peculiar to corporate taxation, most of which favor the corporate form but which are seldom significant in determining whether to incorporate a professional organization. Under Code section 243, corporations are allowed to deduct 85 per cent of dividends received. If the professional association or corporation has such income, it would not be subject to the same tax as ordinary income. The Code imposes lesser restriction on corporate deductions for losses, bad debts, and net operating losses than on similar deductions by other taxpayers. Code section 248 allows a corporation to amortize organization expenses over a five-year period. The Code also accords favorable stock treatment to corporations in certain reorganizations. It should be noted that the employer's share of an employee's social security tax is a deductible expense to the corporation, and no additional income is attributable to the employee.

In summary, most professional organizations would benefit from the tax shelter and miscellaneous advantages provided by corporate taxation. Admittedly, there are certain dangers which must be carefully avoided. If the shelter is not needed or desired, or if unfavorable situations arise, the disadvantageous corporate taxes can often be avoided.

**TAX PROVISIONS AFFECTING COMMON LAW EMPLOYEES ONLY**

At common law, an employee is one who performs services in the business of another, and who is subject to the supervision and control of another, not only as to the result but as to details. For social security, unemployment tax, and wage withholding purposes, an employee has been defined similarly. The Code provides a number of income tax benefits strictly for employees, but "employee" has never actually been defined. The Code also accords favorable stock treatment to corporations in certain reorganizations. It should be noted that the employer's share of an employee's social security tax is a deductible expense to the corporation, and no additional income is attributable to the employee.

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44. Id. § 166.
48. E.g., Reaate, (Second) of Agency § 2(2), Comment d; § 220, Comment g (1958).
49. Treas. Reg. § 31.3121 (d)-1(c)(2); § 31.3306(i)-1(b); §§ 31.3401(c)-1(b), (c) (1956).
50. See text, infra.
defined for federal income purposes. In the absence of a statutory provision expanding the definition, generally it has been given its common law meaning. In short, anyone working for a corporation can be considered as an employee; however, only non-owners can be employees of a partnership or proprietorship. Thus, self-employed individuals traditionally have been denied the benefits accorded "employees."

Pension and Profit-Sharing Plans

Generally, an employer can deduct contributions to non-qualified pension and profit-sharing plans to the extent that such contributions plus regular salaries are reasonable compensation and to the extent that contributions give rise to nonforfeitable rights. The deduction may be taken only if the contributions are paid and the employee receives nonforfeitable rights in the same year. The contributions must be included in the employee's ordinary income if he receives nonforfeitable rights. The ultimate proceeds, in excess of employee contributions and taxed employer contributions, are taxed as ordinary income. The income earned by the unqualified trust or fund is given no tax exemption. Thus, there are few real income tax benefits associated with unqualified plans. If there were such benefits, they would be available to partners who are also employees as defined in Code section 401 (c) (1).

Code section 401 provides for qualified pension and profit-sharing plans.


54. See generally Prentice-Hall, Buying Retirement with Tax Protected Dollars (1968) (Pamphlet No. 462-5); Prentice-Hall, What Profit Sharing Can Do for You and Your Business (1964) (Pamphlet No. 973); Fischer, H.R. 10 Plans and Problems, 14th Ann. WM. & MARY TAX Conf. 29 (1968); Goldstein, Pension and Profit-Sharing Plans: Fallacies and Facts, 38 Taxes 71 (1960); Harl, supra note 27, at 33. Note that stock bonus plans (Int. Rev. Code of 1954, § 401) are generally not be available to a professional association or corporation for the same reasons that stock option plans are not available. See text, infra.


56. Int. Rev. Code of 1954, §§ 402(b), 403(c); Treas. Reg. § 1.402(b)-1(a) (1966). Even if the amounts were treated as gifts, meaning no income tax payable by the employee, the corporation would be limited to a $25 deduction. Int. Rev. Code of 1954, § 274(b).

57. Int. Rev. Code of 1954, §§ 72, 402(b), 403(c).

58. Id. § 404(a) (8).

59. See Treas. Reg. §§ 1.401-1(a) (2) (i), -1(b) (1) (i) (1964).

60. See id. § 1.401-1(a) (2) (ii), -1(b) (1) (ii) (1964).
plans. Under such plans, the employer gets a current deduction, the contributions are invested tax free, and the employee reports no income until he receives the proceeds.  

Until the passage of the Self-Employed Individuals Tax Retirement Act of 1962 (also known as, and hereinafter referred to as, H.R. 10 or the Keogh Plan), the benefits of a qualified plan were not available to partners because they were not employees under the common law definition of the term. Then, Code section 401 (c) extended the definition of “employee” to include self-employed individuals and owner-employees. A “self-employed” person is anyone who owns an interest in a business (other than a corporation) and has “earned income.” An “owner-employee” is a self-employed person who owns 10 per cent or more of such business.

A qualified H.R. 10 plan accords only limited benefits when compared to a qualified corporate plan. Whenever an H.R. 10 plan covers any self-employed person, whether or not he is an owner-employee, a number of disadvantages result.

First, H.R. 10 plans are severely limited with respect to “employer contribution.” Generally, under Code section 404 (e), a self-employed person is allowed to deduct only 10 per cent of his earned income for that year or $2,500, whichever is smaller. Often, not all of the amount actually contributed for a self-employed person may be deducted for tax purposes. By comparison, the corporation is allowed to deduct up to 15 per cent of a participating employee’s earnings for a profit-sharing plan. If both a pension and profit-sharing plan are utilized, a total of 25 percent can be deducted. The importance of this advantage to the corporate form of organization cannot be overemphasized. There is a great benefit in being able to invest in such a way that the business gets a deduction, the beneficiary reports no income (until the proceeds are actually received), and the funds can be invested tax free. Only a qualified plan offers these advantages, and a qualified corporate plan

61. INT. REV. CODE of 1954, § 401.
65. INT. REV. CODE of 1954, § 404(a) (3).
66. Id. § 404(a) (2) (7).
permits much more money to be invested in this manner than does a qualified H.R. 10 plan.

The provisions proscribing when proceeds may be distributed are more restrictive whenever a self-employed individual is covered than otherwise. Annuity proceeds are generally exempt from estate taxation to the extent of an employer's contribution unless the individual covered is self-employed. Until now, capital gains treatment was available except to self-employed persons with respect to proceeds where distribution was made in one taxable year. Furthermore, qualification requirements are much more rigid whenever an owner-employee is covered by an H.R. 10 plan. Thus, "[I]t is necessary that . . . [the owner-employee] provide retirement benefits for his employees if he has any. The plan may not exclude any employee (other than part-time, seasonal, and temporary employees) who has at least 3 years of service." Qualified corporate plans allow greater discretion in excluding employees. The Code provides a mechanical test: 70 percent of all employees must be covered, or 70 percent of all employees must be eligible and 80 percent covered. For this standard neither part-time employees nor employees with less than five years service need be counted. There is an alternative test which allows the plan to cover:

[S]uch employees as qualify under a classification set up by the employer and found by the Secretary . . . not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. . . .

"A classification shall not be considered discriminatory . . . merely because it excludes employees . . . whose remuneration consists of 'wages'. . . ."

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67. Id. § 401(a)(9).
70. This benefit is substantially curtailed by the Tax Reform Act of 1969 (Pub. L. 91-172, § 515 (Dec. 30, 1969), 83 Stat. 643). See note 39 supra and accompanying text. The Act amends Code sections 402(a), 403(a) and 72(n), eliminating capital gains treatment of proceeds with respect to amounts paid by the employer. All proceeds (whether paid to self-employees or other employees) will have the benefit of an averaging method under Code § 72(n).
73. Id.
74. Id. § 401(a)(3)(B).
75. Id. § 401(a)(3).
While a detailed analysis of these sections is beyond the scope of this discussion, some mention of instances in which the Internal Revenue Service has ruled on the qualification of corporate plans is in order, so that the outer limits of the section may be charted.\textsuperscript{76} In 1965 the Service issued four rulings stating its position as to whether a plan qualified under sections 401(a)(3)(B) and 401(a)(5). The first ruling involved a corporation with 109 employees, eighty-three of whom were hourly and were excluded from a salaried plan. Of the twenty-six covered, eleven were members of the “prohibited management group.” The other fifteen salaried people received compensation roughly equivalent to that of hourly employees. This plan was considered to qualify.\textsuperscript{77} Next, a corporation of twenty adopted a salaried plan with a six month eligibility requirement, and a minimum age of thirty years for participation. Seventeen were excluded because they were hourly workers. One was excluded because of the age requirement, and the remaining two were in the “management-group.” This plan was ruled discriminatory,\textsuperscript{78} and hence did not qualify. The other two rulings illustrate a special situation which is of use when collective bargaining units are involved. In Revenue Ruling 66-14,\textsuperscript{79} a corporation of sixty excluded fifty-four members of a union which had no retirement plan. Of the six included, five were in the prohibited group. The plan did not qualify. On the other hand, in Revenue Ruling 66-15\textsuperscript{80} a corporation of sixty-two adopted a salaried plan; the fifty-six excluded members had a collective unit plan. All six of the included group were part of the “prohibited group.” The ruling approved the plan and stated that an employer could contribute more to his salaried-only plan for the prohibited group than to the collective unit plan. The foregoing examples illustrate the latitude allowed with qualified corporate plans. This is in sharp contrast with the strict limits of H.R. 10 plans.

Yet another method of maximizing benefits to higher-paid employees is integration of the plan with Social Security. This is a convenient way of excluding employees from a corporate plan, and section 401 of the Code provides that such a system is not discriminatory.

\textsuperscript{76} This discussion of necessity, is very cursory and explores only the black and white areas described by the rulings infra. The grey areas between the limits cause great difficulty. See Ridley, \textit{Employee Benefit Plans for the Close Corporation}, 45 \textit{TAXES} 188, 194 (1967).

\textsuperscript{77} Rev. Rul. 66-12, 1966-1 \textit{CUM. BULL.} 72.

\textsuperscript{78} Rev. Rul. 66-13, 1966-1 \textit{CUM. BULL.} 73.

\textsuperscript{79} 1966-1 \textit{CUM. BULL.} 75.

\textsuperscript{80} 1966-1 \textit{CUM. BULL.} 83.
The Service first issued rules governing integrated plans in 1951 which were amended in 1953 by Revenue Ruling 53-13. As social security was expanded, the Service issued guidance in Revenue Ruling 56-692 and 61-75. New rules were issued by T.D. 6982 and the 1969 rules amend these.

The reason for allowing this device is that

Integration of a pension plan with social security permits the testing of discrimination in favor of the restricted group on the basis of the combined operation of both the plan itself and the social security system. The latter is deemed to have been provided in part by the employer and to be a substitute for benefits otherwise due under the pension plan itself. The freedom from duplication of its benefits necessarily means that the plan, taken alone, provides a higher over-all benefit rate to higher paid employees than to lower paid employees.

H.R. 10 does not permit integration if more than one-third of the total retirement contributions are made for the higher paid employees. This limits the H.R. 10 plan considerably when compared with qualified plans.

There are several other methods of limiting participation in corporate plans. For example maximum age limitations are allowed. As noted, certain employees may be excluded for purposes of the 70 percent test if the plan contains a waiting exclusion provision. They may also be excluded for purposes of the “non-discrimination test,” but this must be done with care for when a partnership incorporates a “partner’s” service in the older entity is excluded.

Other disadvantages of H.R. 10 plans which cover owner-employees

81. Mim. 6641, 1951-1 CUM. BULL. 41.
82. 1953-1 CUM. BULL. 294.
83. 1956-2 CUM. BULL. 287.
84. 1961-1 CUM. BULL. 140.
85. 1968-2 CUM. BULL. 168.
87. Scheff, Qualified Pension Plans; Discrimination, Deductibility of Contribution; Taxability of Distributions; Separation from Service, N.Y.U. 26th INST. ON FED. TAX. 1027.
88. INT. REV. CODE of 1954, § 401(d)(6); Treas. Reg. § 1.401-12(b).
91. Id. § 401(a)(3)(B).
follow. Immediate vesting is required, and employees' rights must be nonforfeitable.\(^9\) Distributions remaining payable at death must be paid within five years of death or used for the purchase of an annuity.\(^9\) The time when benefits can be paid is even more restrictive when owner-employees are covered by an H.R. 10 plan than when only self-employed individuals are covered.\(^9\) More severe sanctions are imposed for excess contributions.\(^9\) Finally, the exempt status of the trust is held to strict standards with regard to prohibited transactions with owner-employees.\(^9\)

The Tax Reform Act of 1969\(^9\) adversely affects the deferred compensation advantages of professional corporations. It adds a new provision (Code section 1379) which limits "shareholder employees"\(^9\) of an electing Subchapter S corporation to H.R. 10 type pension and profit-sharing plans. The new law nearly eliminates the possibility of a professional corporation or association electing to be taxed under Subchapter S, but does not otherwise affect such an organization. As noted above, the Subchapter S election should not be essential in the case of most professional organizations; others may prefer the election despite this new law. A professional organization would usually benefit from corporate treatment for purposes of pension and profit-sharing plans. That benefit is still one of the most impelling reasons for choosing the corporate form of organization.\(^10\)

**Stock Option Plans**

Should a professional association or corporation be otherwise qualified for the stock option benefits provided by the Code,\(^10\) it is doubtful...
that such plans would be desired because of the closely-held nature of most such organizations. Furthermore, it is doubtful whether they would qualify. First, neither qualified stock options nor stock purchase plans can be accorded to those individuals who own 5 percent or more of the combined voting power or value of all classes of stock.\textsuperscript{102} In addition, because of the all-inclusive employee coverage requirement of stock purchase plans,\textsuperscript{103} a professional association or corporation could not qualify for that type plan. It would not \textit{want} to give non-professional people an interest in the business, and it would not be \textit{allowed} to do so under most state statutes.\textsuperscript{104} A restricted stock option would not be available for plans currently being adopted.\textsuperscript{105} Thus, in the unlikely event the owners of a professional corporation are willing to dilute their ownership by way of stock options, qualified stock options under Code section 422 would be the only tax favored plan available.

\textit{Other Tax Advantages Available Only to Common Law Employees}

Health and accident plans are another important fringe benefit available to corporations and their employees.\textsuperscript{106} These are not available to self-employed individuals. A self-employed individual may, however, exclude from gross income amounts received through health insurance or for personal injury to the extent they are attributable to his own nondeductible expenses.\textsuperscript{107} Thus, the advantage of incorporation is mitigated somewhat as it was with H.R. 10 plans. The general rule is that amounts received by an employee for personal injury or sickness through accident and health insurance are taxable to the extent actually paid by the employer or to the extent attributable to employer contributions which were not includable in the gross income of the employee.\textsuperscript{108} If

\textsuperscript{102} Int. Rev. Code of 1954, §§ 422(b) (7), 423(b) (3).
\textsuperscript{103} Id. § 423(b) (4).
\textsuperscript{105} Int. Rev. Code of 1954, § 424.
\textsuperscript{106} Id. §§ 105, 106. See generally Harl, supra note 27, at 28-30; Harris, \textit{Deductibility of Employees' Medical Expenses and Sickness, Accident and Health Plans}, N.Y.U. 17th Inst. on Fed. Tax. 207 (1959); Pyle, \textit{Accident and Sickness Insurance Under Code Sections 104, 105, 106 and 213}, 34 Taxes 363 (1956). Section 105 was added as a new section to the 1954 Code for the purpose of providing uniform tax treatment to amounts received under employer accident or health plans whether or not the plans are funded by insurance. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 15.
\textsuperscript{107} Authorities cited in note 106 supra.
\textsuperscript{108} Int. Rev. Code of 1954, § 105(a).
such amounts fall within one of the following exceptions, however, they are not taxable. 1. Medical expense reimbursements. These are totally excludable from gross income, whether the employer plan is insured or uninsured, and whether payments are made to the person or the institution, or to the spouse or dependent. 2. Permanent injury payments. Under Code section 105 (e) amounts received from an employer plan for loss of a member or function of the body, or for disfigurement of the taxpayer, his spouse, or dependents, computed with regard to the nature of the injury, and not the period of absence from work, are excluded from gross income. 3. Wage continuation payments. Under Code section 105 (d) amounts paid under an employer-financed wage continuation plan in lieu of wages are excluded from gross income. The amount is limited to a specified weekly rate. The following conditions must be met:

1. The amounts are paid as wages or in lieu of wages, to an employee;
2. The payments are made pursuant to a wage continuation plan;
3. The employee is absent from work;
4. The employee's absence is the result of personal injury or sickness;
5. Payments are made for a limited period only, such as 13 or 26 weeks.

The employer may deduct contributions to, or direct payments under, plans financed by commercial insurance; state disability funds; uninsured plans of the employer which may or may not comply with a state nonoccupational disability statute; collectively bargained plans; an agreement among, or association of, employers or employees; a section 401 trust; and a qualified charity.

Code section 106 provides that, “Gross income does not include contributions by the employer to accident or health plans for compensation . . . to his employees for personal injuries or sickness.”

109. Id. § 105(b). Medical expenses are defined in Id. § 213, Treas. Regs. § 1.213-(1)-(2) (1968).
111. Id. § 1.105-4 (1966).
112. Id. § 1.105.4(a) (1) (1966).
113. Id. § 1.105-4(a) (2) (i) (1966).
114. Id. § 1.105-4(a) (2) (ii) (1966).
115. Id.
116. Id. § 1.105-4(a) (2) (1) (1966).
117. Tax Management, Portfolio No. 43 at 87.
added. In short, these sections allow an employer to provide employee benefits, the costs of which are deductible by the employer but generally not includable in the income of the employee, and the proceeds of which are tax free when received by the employee.

Different plans are allowable for different classes of employees as long as they are of benefit to the employees. In *A.B. Larkin* the court held that payments were not excludable because the taxpayer did not prove the purpose of the plan was to benefit employees. The court believed it was for the benefit of stockholders. This holding, however, has given rise to a conflict, for in *Bogiene, Inc.* the court found it immaterial that a plan benefitted shareholders because Congress intended to allow discrimination in this area. The unsettled nature of the issue makes discrimination a dangerous practice, especially in view of the fact that *Larkin* is a court of appeals case and *Bogiene* ended at the Tax Court.

Another fringe benefit accompanying corporate status is group term life insurance purchased for employees. Generally, employees must include as income the cost of group term life insurance provided directly or indirectly by their employer to the extent such cost exceeds the cost of $50,000 of such insurance. To qualify, the plan must make the insurance available to a group of lives, and such group must include employees on the basis of factors which preclude individual selection. This of course is an ordinary business expense. These benefits are limited to common law employees.

Code section 101(b) provides yet another fringe benefit to the employees of a corporation. It stipulates that amounts up to $5,000 which are paid to the beneficiaries or the estate of an employee, or former employee, by or on behalf of an employer and by reason of the death of the employee shall be excluded from the gross income of the recipient. This provision expressly excludes self-employed individuals. In es-

119. 48 T.C. 629 (1967), aff'd, 394 F.2d 494 (1st Cir. 1968).
120. See also Levine, 50 T.C. 422 (1968).
123. Id.
124. Treas. Reg. § 1.79-1(b) (1)(iii)(b) (1969). State insurance laws should be examined for restrictions on group policies.
establishing such a plan, care must be taken to avoid possible difficulty with section 401. If the amount is provided under a pension or profit-sharing plan\textsuperscript{128} it may qualify for section 101 (b); however, a payment pursuant to the provisions of section 401, because of the death or retirement of the individual before the event, appears not to qualify under section 101 (b).

Another benefit accruing to the corporation is the deductibility of travel and entertainment expenses. If other requirements are met, a fixed mileage allowance of up to fifteen cents per mile and a per-diem allowance of up to $25 per day will be deemed to satisfy the employer's substantiation requirements under Treas. Reg. section 1.274-5 (c) and will be deductible.\textsuperscript{129} Such amounts will also be deemed as satisfying the adequate accounting requirements of Treas. Reg. section 1.274-5(e); and will not be includable in an employee's income if such amounts do not exceed his actual related deductible expenses, or ten cents per mile for the first 15,000 miles and seven cents thereafter without further substantiation,\textsuperscript{130} whichever is greater. Other requirements enumerated are that the employer reasonably limit such payments, that details concerning time, place and business purpose be substantiated, and that such payments reasonably approximate actual costs. An employee who owns more than 10 percent of the stock is not permitted a fixed per diem allowance. Thus, in certain cases there will be a substantive advantage available to the corporation and its employees. In addition, precise rules for reporting travel and entertainment expenses are established for employees.\textsuperscript{131}

**OTHER TAX CONSIDERATIONS**

**Reporting Procedure Generally**

The corporate income tax return (Form 1120) will replace the partnership information return (Form 1065), and the professional will not have to file Schedule C with his Form 1040.

**Withholding Generally**

Tax withholding will replace the quarterly estimated payments as far

\textsuperscript{128} Id. § 401 et seq.


\textsuperscript{131} Treas. Reg. § 1.162-17 (1958).
as professional income is concerned. This might be preferable, especially if an individual has little income not subject to withholding.

Estate Planning

A professional association or corporation generally has continuity of life and each professional owns stock in this going corporation. At the death of one of these stockholders, his estate owns a valuable disposable asset. Cross-purchase agreements or other means can be used to retain the actual ownership within the professional group. An unincorporated practice has no continuity of life and a partner's interest loses its value at his death. As with stock option plans, state licensing provisions preclude some of the advantages.

Miscellaneous Corporate Taxes and Expenses

State statutes impose certain taxes strictly on corporations. Original charter fees, charter fees on changes in authorized capital stock, annual registration fees, and annual franchise taxes are examples. If an organization is treated as a corporation for federal income tax purposes, it probably will be so treated for purposes of these state taxes. The amount involved will probably be relatively insignificant in the usual case. Many states impose an income tax on professional associations or corporations, but not on partnerships, just as the federal income tax laws do. Since most such organizations will have little income after salaries and other expenses, the tax will probably be insignificant. State statutes should be checked, however, for they might impose a burden, in some cases, offsetting a federal tax advantage.

There will be certain other expenses, such as legal fees, involved with the initial change. Again, these should be insignificant compared with the tax advantages anticipated.

134. E.g., id. § 58-445.
135. E.g., id. § 58-450.
136. E.g., id. § 58-456.
137. However, Virginia apparently does not impose these taxes and fees on professional associations. See id. § 54-898 (Replacement Vol. 1967) where a separate license is required for each member of the firm in lieu of other revenue licenses.
Accounting Period

Generally, a partnership must use the taxable year of its principal partners, and the principal partners are not permitted to change this reporting period at will.\(^\text{139}\) A corporation is allowed more flexibility in choosing its taxable year under Code section 441.

Workmen’s Compensation

Usually, partners do not qualify as employees for payments under state workmen’s compensation laws.\(^\text{140}\) The exclusion of such payments from gross income for federal income tax purposes, however, is not limited to employees.\(^\text{141}\)

Distribution of Ownership

Owners of a professional corporation or association cannot spread the ownership and, thus, the profits of the business by giving stock to members of the family. Since a professional organization should have little profit after salaries, the amount retained to pay dividends would be unduly subjected to the corporate tax. In any event, most state statutes\(^\text{142}\) prevent non-professionals from owning stock.

CONCLUSION

For most professionals, association or incorporation for federal income tax purposes still appears to be a worthwhile idea. The general tax imposed on corporations will not materially affect most professionals and can often be used as a shelter to their advantage. Qualified corporate type pension and profit-sharing plans have many advantages for professionals over H.R. 10 plans. Under the Tax Reform Act of 1969 the corporate type plans will not be available to electing Subchapter S corporations. Thus, Subchapter S will no longer be as viable an alternative for professionals; however, the other advantages of a professional association or corporation remain. Another important consideration is the favorable treatment given group term life insurance and health and accident plans which cover shareholder-employees, but not partners. There are many other relatively minor tax provisions which should be

\(^{139}\) INT. REV. CODE of 1954, § 706(b).  
\(^{140}\) E.g., VA. CODE ANN. § 65.1-4 (Replacement Vol. 1968). Definition of “employee” apparently agrees with common law meaning and excludes partners.  
\(^{141}\) INT. REV. CODE of 1954, § 104(a) (1).  
\(^{142}\) E.g., VA. CODE ANN. § 54-888 (Replacement Vol. 1967).
considered. When all factors are carefully analyzed, most professionals will find it advantageous at least for purposes of federal income taxation, to form a professional association or corporation pursuant to state law.

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