North Dakota Law Review

Volume 41 | Number 3 Article 1

1964

The Professional Corporation

Garry A. Pearson

NORTH DAKOTA LAW REVIEW

VOLUME 41 MARCH 1965 NUMBER 3

THE PROFESSIONAL CORPORATION

GARRY A. PEARSON*

During the reign of the second King of Rome, Numa Pompilius (715-672 B.C.), there existed a heated dispute between the Romans and the Sabines, both occupants of the newly created City of Rome. As a political solution to an apparently irreconcilable conflict, Numa resorted to the already ancient tactic of "divide and conquer," but Numa's method was unique; he separated the townsfolk into clearly definable economic groups with an independent existence within the group that transcended the life of the members. Romans and Sabines alike formed the nucleus of what many textwriters describe as the first recorded instance of the use of the corporation.[1]

So too, in the twentieth century, a unique form of organization has arisen, again as a political solution to a conflict—this time between the tax gatherer and the gathered. It is the professional corporation, a form which has been labeled and treated as a corporation by the state government, attacked by the federal government, criticized by some as unprofessional, approved by august bodies as thoroughly respectable, and given a collection of so many varying attributes as to be a creature of doubtful legitimacy.

On July 1, 1963 the Professional Corporation Act became law in North Dakota.[2] It appeared that the Internal Revenue Service would bless this newborn creature, since the only positive expression of opinion at that time was a letter ruling favoring a professional corporation for a group of doctors in Connecticut.[3] On December 17, 1963, however, the Internal Revenue Service proposed certain regulations[4] casting doubt in this area of the law; these regulations were then substantially adopted on February 2, 1965.[5] The stage

*Arnason & Pearson, Grand Forks, North Dakota. B.S.B.A. 1956, J.D. 1958, North Dakota. C.P.A., 1957. Trial Attorney, Tax Division, United States Department of Justice, 1958-1961.

1. 1 PLUTARCH, LIVES 151-152 (Clough ed. 1906).
2. N.D. CENT. CODE § 10-31 (Supp. 1963).
3. "The clinic is incorporated under the laws of Connecticut, and is taxable as a corporation under the provisions of '54 Code Reg. § 301. 7701-2(a)(1), since it has more corporate characteristics than non-corporate characteristics. Doctor-members are employees because of the substantial nature, regularity and continuity of the services performed and the authority vested in the clinic's Board of Directors." 4 P-H 1961 FED. TAX SERV. ¶ 54753.
4. Proposed Treas. Reg. § 301.7701-2, 28 Fed. Reg. 13751 (1963).
5. Treas. Reg. § 301.7701-2 (1965), as amended, T.D. 6797, 1 P-H 1965 FED. TAX SERV. ¶ 3203.

is now set for the inevitable attack on those regulations, and practitioners must be aware of the great uncertainty which attends the formation of such a corporation under the present state of the law.

Few readers will fail to identify the garden-variety corporation and may well wonder at their supposedly more specialized brethren. Legerdemain is all too often exalted in federal taxation, and nowhere is it better exemplified than in differentiating between similar organizations. Since Congress has imposed varying rates, exemptions and deductions for varying entities, it has been necessary to define the characteristics of each form of organization. Taxation being an essentially practical matter, the substance of a thing must control over its form;[6] hence, a corporation is something more than a group with a charter from the state. For federal taxation purposes, "the term 'corporation' includes associations, joint-stock companies, and insurance companies."[7]

Congress has thus by definition broadened the scope of the term "corporation" to include groups which would not, at common law, be termed as such. This obviously left much to be desired and required, at a relatively early time, Supreme Court interpretation. In *Morrissey v. Commissioner*,[8] a group of investors formed a trust for the purpose of operating a golf course, subdividing, selling, renting real estate, and managing the property, and bound themselves to a trust agreement which would continue for twenty-five years. Two thousand preferred and common shares were authorized to evidence the beneficial interests. The trust declared the trustees powerless to bind the beneficiaries personally by any act or default. The Commissioner insisted that this organization should be taxed as a corporation, essentially for the reason that the described enterprise exhibited pronounced corporate attributes, and the Supreme Court agreed. In the Court's opinion, a corporation

1. "holds the title to the property . . ."
2. "furnishes the opportunity for centralized management through representatives of the members . . ."
3. "may be secure from termination or interruption by the death of the owners . . ."
4. "facilitates . . . the transfer of beneficial interests . . ." and
5. "permits the limitation of personal liability . . . ."[9]

Several companion cases decided with *Morrissey* confirmed the same philosophy.[10] The Commissioner thereafter issued orders to his

6. Gregory v. Helvering, 293 U.S. 465 (1935).
7. INT. REV. CODE of 1954, § 7701(3).
8. 296 U.S. 344 (1935).
9. *Id.* at 359.
10. Swanson v. Commissioner, 296 U.S. 362 (1935); Helvering v. Combs, 296 U.S. 365 (1935); Helvering v. Coleman-Gilbert, 296 U.S. 369 (1935). *Accord,* Lewis & Co. v. Commissioner, 301 U.S. 385 (1937).

agents to apply an objective nation-wide standard which relied upon a mechanical test, namely, does the entity have more of the characteristics native to a corporation than a partnership.[11] During this period tax rates on individuals and corporations alike were relatively low[12] and the impetus for profit-sharing plans, death benefits, deferred income plans and other sophisticated tax saving approaches did not arrive until the steeply progressive rates of World War II.

In *Pelton v. Commissioner*[13] the government won a case it still seeks to live down. A group of physicians and surgeons organized a medical clinic, in trust, for the practice of medicine, specifying centralized management, a degree of transferability of interests, associates engaged in the practice of a profession for profit, and continuity of interest. Because of the striking similarities with *Morrissey* and its companion cases, the Commissioner proposed to tax the medical clinic as a corporation, while the doctors contended that the trust income should be taxed to the beneficiaries, since Illinois law prevented them from practicing in the corporate form.[14] The Court of Appeals considered that *Morrissey*, decided only a few weeks earlier, was dispositive of the petitioner's claim, as state law is of no importance for purposes of taxation.[15]

Following the introduction of the steeply progressive income tax rates of 1942,[16] ways were sought by professional persons to level out their income, or provide a method of accumulating funds for retirement with tax consequences. In 1938 Congress passed what became section 165(a) of the Internal Revenue Code of 1939,[17] the predecessor of the present section 401 of the Internal Revenue Code of 1954, which created the tax exemption for profit sharing and pension plans designed to benefit "employees." This obviously operated to the disadvantage of the self-employed, and particularly those who could not incorporate and thereby become "employees" of their own corporations.

Most of these advantages have today become fairly well known. For example, contributions to a profit sharing plan qualified under section 401, for the benefit of employees, may be deducted from corporate income to the maximum amount of fifteen per cent of the employee's gross wages; while in trust these contributions earn interest and dividends free of tax, and the return of the trust fund is taxed at capital gains rates when the employee is disabled or retired and his rate is low.[18] In a similar fashion the corporate

11. Mim. 4483, XV-2 CUM. BULL. 175 (1936).
12. See Revenue Act of 1938, ch. 289, §§ 11-13, 52 Stat. 447.
13. 82 F.2d 473 (1936).
14. People v. United Medical Service, 362 Ill. 442, 200 N.E. 157 (1936).
15. *Supra* note 13, at 476.
16. See Int. Rev. Code of 1939, ch. 1, § 12(a), 53 Stat. 5, as amended by Revenue Act of 1942, ch. 619, § 103, 56 Stat. 798.
17. Revenue Act of 1938, ch. 289, § 165(a), 52 Stat. 518. Similar acts have existed since 1916. See, *e.g.*, Act of September 8, 1916, ch. 463, § 2(b), 39 Stat. 757.
18. INT. REV. CODE of 1954, § 401(a).

employee can enter into a contract with the corporation to pay his income over a period beyond his earning years, hence deferring the tax and leveling income, perhaps postponing it until retirement when rates become much lower and additional exemptions are available.[19] If desired, the 5,000 dollar death benefit can be given tax free to the widow of a corporate employee,[20] and tax free accident and health programs,[21] group insurance for larger groups and disability contracts are available.[22]

In 1954 a group of Montana doctors formed a clinic under Articles of Association which, in general, provided that the Association would have perpetual existence, centralized management, a form of limited liability, and several associates for the carrying on of a business with the intent of dividing the profits therefrom. In effect, this group sought to tailor-make its organization to fit the mold cast by *Morrissey, Pelton* and similar cases. From a judgment for the doctors,[23] the government appealed to the Ninth Circuit, which affirmed.[24] In both the trial court and the Court of Appeals the government urged the proposition that local law, that is, the Montana prohibition of the corporate practice of medicine,[25] was the determining factor, an argument that the Commissioner had successfully resisted in *Pelton*.[26] The Court of Appeals refused to overturn twenty or more years of practice, and answered:[27]

> The Government's contention, based on the proposition that because, under local law, a corporation is not allowed to practice medicine, the group is not an association, would introduce an element of uncertainty which neither the courts nor the regulations have recognized.

At least three of the five tests attributed to *Morrissey* were found to be present in the Association in *Kintner*. The Association held title to property, had centralized management, and was not terminated by death or withdrawal of an owner; but it lacked free transferability of interests and limited liability, although only the members were liable for professional misconduct. The permanence of the organization was stressed and, on the whole, both the trial and reviewing court considered the organization sufficiently analogous to a corporation. In *Galt v. United States*,[28] virtually the

19. A "cash-basis taxpayer" reports income when received. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.
20. INT. REV. CODE of 1954, § 101(b).
21. *Id.* § 106.
22. *Id.* §§ 105(c), 105(e).
23. Kintner v. United States, 107 F. Supp. 976 (D. Mont. 1952).
24. United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).
25. MONT. REV. CODES ANN. § 15-104 (1955). In 1963 Montana enacted the Professional Service Corporation Act, MONT. REV. CODES ANN. § 15-2101 to -2116 (Supp. 1963), and added the "rendering of professional services" to the list of approved corporate purposes. MONT. REV. CODES ANN. § 15-104(33).
26. *Supra* note 13.
27. *Supra* note 24, at 423.
28. 175 F. Supp. 360 (N.D. Tex. 1959).

same set of facts resulted in another victory for a medical clinic and significantly, no appeal was taken.

On November 15, 1960 the Commissioner promulgated new regulations defining and classifying taxpayers.[29] These regulations were obviously precipitated by the decisions in *Kintner* and *Galt*, since they expressly based the distinctions between corporations, partnerships, associations and the like on local law. For example, the regulations conclude that an organization or association lacking a corporate charter in a state which has adopted the Uniform Partnership Act[30] could not qualify as a corporation; death or resignation of a member effects a termination of the entity and hence prevents centralization of management and continuity of life, since any member of a partnership or association governed by partnership law can effectively block group action simply by resigning or threatening to resign.[31] It may be believed that such regulations, if valid, would have compelled a different result in *Morrissey*, *Pelton* and other pre-*Kintner* decisions.

These regulations spawned the next step, the wholesale enactment of professional corporation statutes.[32] The proponents of such legislation convincingly argued that since local law is the test to which the courts must look under the new regulations, local law will be changed to satisfy the new regulations. The mountain had come to Mohammed.[33] In the first published controversy a group of doctors in Connecticut formed a professional corporation for the practice of medicine, and requested a revenue ruling on their tax status. The Commissioner approved that group for corporate tax treatment,[34] based upon local law, *i.e.*, Connecticut's Medical Group Clinic Corporations Act.[35] However, the scene suddenly became silent; no further rulings were made and it became apparent that the Commissioner was about to take further action. That action came on December 17, 1963 when the present regulations were proposed.[36] These were publicly heard during March, 1964 and

29. Treas. Reg. § 301.7701-2 (1960).

30. The Uniform Partnership Act has been adopted in thirty-nine states, the District of Columbia, the Virgin Islands and Guam. See, *e.g.*, N.D. CENT. CODE § 45-05 to -09 (1960).

31. Moreover, these regulations state: "Nevertheless, if, notwithstanding such agreement [of association setting a fixed life as in the *Morrissey* case], any member has the power under *local* law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life." (Emphasis added). Treas. Reg. § 301.7701-2(b)(3) (1960).

32. Such acts, varying in form and coverage, are law in thirty-three states. 1 P-H 1965 FED. TAX SERV. ¶ 3216.

33. It has become increasingly popular to solve federal tax problems with local statutes. Witness the Uniform Gifts to Minors Act, N.D. CENT. CODE § 47-24-02 (1960), designed to preserve the gift tax exemption.

34. "The clinic is incorporated under the laws of Connecticut, and is taxable as a corporation under the provisions of '54 Code Reg. § 301.7701-2(a)(1), since it has more corporate characteristics than non-corporate characteristics. Doctor-members are employees because of the substantial nature, regularity and continuity of the services performed and the authority vested in the clinic's Board of Directors." 4 P-H 1961 FED. TAX SERV. ¶ 54753.

35. CONN. GEN. STAT. REV. § 33-180 to -182 (1962).

36. Proposed Treas. Reg. § 301.7701-2, 28 Fed. Reg. 13751 (1963).

became final on February 2, 1965.[37] In truth these regulations seek to return to the doctrine of the *Morrissey* case; lip service is given to local law, but a federal standard is applied when determining whether or not a professional group will qualify for corporate tax treatment. For example, the regulations state:

> Nevertheless, the labels applied by local law to organizations, which now or hereafter may be authorized by local law, are in and of themselves of no importance in the classification of such organizations for the purposes of taxation under the Internal Revenue Code. Thus a professional service organization, formed under the law of a State authorizing the formation by one or more persons of a so-called professional service corporation, would not be classified for the purposes of taxation as a "corporation" merely because the organization was so labeled under local law. See Morrissey et al. v. Commissioner, 296 U.S. 344 (1935). . . . [38]

> Moreover, although a measure of central control may exist in a professional service organization, the managers of a professional service organization in which a member retains traditional professional responsibility cannot have the continuing exclusive authority to determine all of the matters described in the preceding sentence. . . . Therefore, centralization of management does not exist in such a professional service organization.[39]

> If local law, applicable regulations, or professional ethics do not permit a member of a professional service organization to share in its profits unless an employment relationship exists between him and the organization, and if in such case he or his estate is required to dispose of his interest in the organization if the employment relationship terminates, the continuing existence of the organization depends upon the willingness of its remaining members, if any, either to agree, by prior arrangement or at the time of such termination, to acquire his interest or to employ his proposed successor. . . . Consequently, such a professional service organization lacks continuity of life.[40]

In many other ways the regulations would deny corporate status to the professional corporation, but it would not serve our purposes to repeat them here. It seems fair to conclude that the regulations were written deliberately to foreclose forever any hope of establishing legitimacy to such an entity. For this reason it would indeed be an impetuous counsel who would advise a client to organize under the North Dakota Act without bracing one's self for battle.

It must be remembered, on the other hand, that the Commissioner

37. Treas. Reg. § 301-7701-2 (1965), as amended, T.D. 6797, 1 P-H 1965 FED. TAX SERV. ¶ 3203.
38. *Id.* § 301.7701-1(c).
39. *Id.* § 301.7701-2(h)(3).
40. *Id.* § 301.7701-2(h)(2).

cannot rewrite the law; his regulations must be a fair diagnosis of what the law is, and when he exceeds the duty of interpretation and commences to write new law, his regulations will be held invalid.[41] The new regulations strain to incorporate the logic of the *Morrissey* case with the result desired by the Revenue Service in *Kintner*, and the two may well be irreconcilable. In any event the practitioner must realize that no early determination will be available.

We have now turned full circle, from federal test to local law test and back to federal test. No one can predict the fate of the professional corporation movement, if one may call it that, but one can certainly bemoan the uncertainty attendant to this entire field. For more than ten years the up and down controversy has raged, thereby rendering unstable a vehicle for transacting a business which must have, above all attributes, the advantage of stability. Moreover, one must mourn the effort expended in unrealistic pursuits; a professional corporation may not be in fact a corporation because of the limitations of professional ethics[42], but the professional person merely seeks to join his non-professional brother who can easily enjoy the advantages of the corporate form.

41. Manhattan General Equipment Co. v. Commissioner, 297 U.S. 129 (1936).

42. Yet one should not lose sight of the fact that several professions permit incorporation under the Business Corporation Act. For example, architects, engineers and pharmacists combine in this form with the approval of their professional societies. Note also that the North Dakota Professional Corporation Act does not include the rendering of a service which, prior to the passage of the act, *"could not be performed by a corporation."* (Emphasis added). N.D. CENT. CODE § 10-31-01(1) (Supp. 1963).