COMMENTS

QUASI-CORPORATE PROFESSIONAL SERVICE ASSOCIATIONS AND THE KINTNER REGULATIONS

I. INTRODUCTION

For income tax purposes, taxpayers are classified as individuals (including partners), as trusts or estates, or as corporations. All organizations, however labeled, must be placed into one of these three categories in order for tax liability to be determined.

While the Internal Revenue Code of 1954 specifies that an "association" is taxable as a corporation, the Code does not define the term "association." Nevertheless, court decisions and Treasury Regulations have spelled out certain tests to be applied in determining whether a taxable organization has such characteristics that it qualifies as an association. If the tests set forth are satisfied by the organization, it is said to have achieved the tax status of a corporation for federal tax purposes and is able to qualify for the benefits accorded to corporations by tax law.

Traditionally, organizations of professional people such as lawyers, accountants, physicians, dentists, veterinarians, and chiropractors have not been able to meet the requirements for corporate tax treatment, principally because they have neither sought nor have been able to organize in such a manner as to display the basic characteristics necessary to satisfy the requirements for corporate treatment. Therefore, by operating their enterprises as proprietorships or partnerships, professional persons have failed to qualify for the employee benefit plans and other tax-favored benefits available only to corporate employees.

Because of their inability to participate in the various tax advantages available to corporate organizations, some professional

3. An alternative is presented to these professional groups in the form of a self-employed retirement plan popularly known as the "Keogh Plan." This plan allows self-employed persons to contribute up to ten per cent of their annual earned income to a retirement fund. Such contributions may be taken in full as deductions on annual state and federal income tax returns, and the fund may then be drawn upon in retirement years. The income earnings in the fund thus may be compounded on a tax-free basis and become subject to income tax only when they are distributed under the terms of the plan.
groups have attempted to set up a form of operation that exhibits the characteristics necessary to achieve corporate tax status, enabling them to gain the tax benefits other corporate organizations enjoy. However, such attempts have met with disapproval by the Treasury Department. The Treasury has taken the position that professional service associations are subject to special restrictions which necessarily deprive them of the usual characteristics of an ordinary business corporation. In effect professional associations have been refused corporate tax treatment and its advantages.

Despite the position taken by the Treasury Department in refusing to sanction corporate treatment of professional service associations, efforts on the part of professional groups have continued and have met with considerable success in the courts. Each time a ruling favorable to a professional association has been made, however, the Treasury Department has amended its Regulations in an attempt to neutralize the decision.

The controversy between the Treasury Department and the courts on the issue of whether professional associations can qualify for corporate tax treatment is the subject of this discussion. In examining the controversy, it will be necessary to consider the pertinent court decisions which have recognized the status of professional associations as quasi-corporate organizations and Treasury Department rulings which have attempted to settle the controversy, but failed when confronted by subsequent efforts of professional groups seeking to attain corporate status.

II. HISTORY

It was in the landmark case of Morrissey v. Commissioner, that the Supreme Court of the United States established that the proper classification of an unincorporated organization for federal purposes depended upon whether its essential characteristics more closely resembled those of a partnership or those of a corporation. Discarding previous tests, the Court set forth six major

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5. 296 U.S. 344 (1935). In this case the United States Supreme Court was called upon to settle a hopeless state of confusion in the courts, which had arisen because of a conflict of decisions as to the distinction between an "association" and a "pure trust." The beneficial control test, which had been the standard applied previously, was found to have resulted in great uncertainty, and for this reason the Court promulgated new standards to aid in the determination of whether an organization was an association or a trust. The test adopted included associations with corporations if they had a preponderance of corporate characteristics. "The inclusion . . . with corporations implies resemblance; but it is resemblance and not identity." Id. at 357.
characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other forms of organization. They are:

1. The presence of associates;
2. an objective to carry on business and divide the gains therefrom;
3. continuity of life;
4. centralization of management;
5. liability for corporate debts limited to corporate property;
   ·and

6. free transferability of interests.\(^6\)

The classification procedure under the \textit{Morrissey} criteria is a simple, arithmetical one, especially as applied by the Internal Revenue Service. The test is simply that an unincorporated organization will not be classified as an association, and therefore will not be taxable as a corporation, unless such organization has more corporate than noncorporate characteristics. In making this determination, characteristics common to both corporate and noncorporate forms are disregarded.

The \textit{Morrissey} test was applied and reaffirmed in 1936 in \textit{Pelton v. Commissioner},\(^7\) which involved three Illinois physicians who had organized and operated a medical clinic in the form of a trust with themselves as trustees. They divided beneficial interests, exempted themselves from personal liability for debts incurred by the trust, and provided that beneficiaries should fill vacancies on the board of trustees. The Commissioner ruled that the organization was an association under section 2(a)(2) of the Revenue Acts of 1924\(^8\) and 1926.\(^9\) The Seventh Circuit affirmed, holding that \textit{Morrissey v. Commissioner}\(^10\) was determinative of the question. Under the \textit{Morrissey} test, the Pelton Clinic trust was an association, since it was carried on for profit, and all the substantial points of resemblance to a corporation were present in the organization.

It is noteworthy that the trust qualified as a corporation despite the fact that it was unlawful for a corporation to practice

\(^6\) Id. at 359. The first two characteristics, the existence of associates and an objective to carry on business and divide the gains therefrom, are characteristics that are common to both partnerships and corporations, and for this reason they, in effect, cancel each other out and leave the remaining four criteria as the true substance of the test. However, the first two characteristics must be found to be in existence before any organization may be treated as a corporation.
\(^7\) 82 F.2d 473 (7th Cir. 1936).
\(^8\) 43 Stat. 253 (1924).
\(^9\) 44 Stat. 9 (1926).
\(^10\) 296 U.S. 344 (1935).
medicine in Illinois. However, the court felt that sections 65 and 69 of the Treasury Regulations sufficiently covered the situation in providing that "organizations are associations within the meaning of the statute even though under State law such organizations are technically partnerships."

This was the state of the controversy in 1954, when Dr. Arthur Kintner and his partners dissolved the partnership under which they had been conducting their Western Montana Clinic and executed "Articles of Association," which provided that the members "associate themselves together for the practice of medicine and surgery as an unincorporated association," which was to be endowed with the "attributes of a corporation" and to be "treated as a corporation for the purposes of taxation." The articles also provided for termination upon the death of the last survivor, management by an executive committee composed of five of the original eight members, and for determination of salaries by the executive committee. In addition any indebtedness incurred by the Association through the act of a member without authority conferred by the committee was chargeable against such member's share of the earnings of the Association, and only members were made liable to third parties for professional misconduct. The doctors became employees and the Association set up a pension trust for the

11. People v. United Medical Service, 362 Ill. 442, 200 N.E. 157 (1936). But cf. State Electro-Medical Inst. v. State, 74 Neb. 40, 103 N.W. 1078 (1905), wherein it was held by the Supreme Court of Nebraska that a duly licensed physician may form a corporation in order to make contracts for the services of its members and to collect the compensation due thereon. The contention of the state was that the corporation itself was practicing medicine, rather than the member-employees. Therefore, the state reasoned, the State Electro-Medical Institute was in violation of chapter 55 of the Compiled Statutes of 1881 (Reissue 1903, Neb. Laws c. 60, § 1 (1903), now NEB. REV. STAT. § 71-102 (Reissue 1966)), which required that all persons practicing medicine should first obtain a license. The State Electro-Medical Institute could not obtain such a license because a corporation was not such a person as could be licensed to practice medicine. However, the court determined that the corporation as an entity was not practicing medicine. Rather, the qualification of a medical practitioner was personal to himself, and therefore only the members were "practicing medicine." The corporation was merely making the contracts for the physicians. See also State Electro-Medical Inst. v. Platner, 74 Neb. 23, 103 N.W. 1079 (1905). The former decision was referred to in an opinion of the attorney general of the State of Nebraska dated June 14, 1947. The attorney general reasoned that:

[1] It must be assumed that our courts will continue to follow the rule announced in State Electro-Medical Institute v. State, and under the rule I believe the corporation in question cannot be said to be engaging in the practice of dentistry.

doctor-employees, instead of giving them an interest in the assets.

Despite the presence of the foregoing characteristics, the Commissioner determined that the enterprise was taxable as a partnership and not as an association. However, the United States District Court for the District of Montana\(^1\) and the United States Court of Appeals for the Ninth Circuit\(^2\) disagreed with his ruling. The district court placed great reliance on *Morrissey v. Commissioner*\(^3\) in making its determination that the medical association was indeed a corporation for income tax purposes. After briefly summarizing the features of an enterprise that permit it to be regarded as a corporation, the district court referred to the following language of the Supreme Court in the *Morrissey* case:

> While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive.\(^1\)\(^4\)

The court felt that this language indicated that an enterprise need not meet all six of the tests suggested in *Morrissey*, but rather that an organization should be closely examined to ascertain whether it more closely resembles a corporation or a partnership, and that its status should then be declared in accordance with the "balance of resemblance."\(^1\)\(^5\)

Applying this interpretation, the district court found that the Western Montana Clinic Association met the *Morrissey* criteria in that title was held in the name of the Association, management was centralized, and the Association had a continuous existence, since it would not terminate upon the death or withdrawal of a member. The court did not think that the sixth test, requiring the facilitation of the transfer of beneficial interests without affecting the continuity of enterprise, was met. However, although it did not resemble a corporation in this respect, neither did it resemble a partnership. As to the fifth test, that liability be limited to the organization’s initial assets, the court felt that the Association more closely resembled a partnership than a corporation.

In addition to the considerations based upon the *Morrissey* standards, the court also found that the definitions contained in the Internal Revenue Regulations\(^1\)\(^6\) clearly indicated that the West-

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16. Id.
17. 26 C.F.R. § 29.3797 (1941). The pertinent text is set out in the Appendix, § B *infra* at 129-30.
tern Montana Clinic Association was an “association” and therefore taxable as a corporation.

The Government appealed to the United States Court of Appeals for the Ninth Circuit, relying there upon its only substantial argument—that the laws of Montana did not include the practice of medicine as one of the purposes for which a corporation may be organized. However, the Ninth Circuit cited as controlling the decision in Pelton v. Commissioner, where a professional association was found to qualify as a corporation even though under state law it was technically recognized as a partnership. The court of appeals also confirmed the finding of the district court that the Montana association had a preponderance of corporate characteristics as determined by the standards set out in Morrissey. The court stated that the Government’s contention ran counter not only to the policy of the Internal Revenue Department not to be bound by state law, but also contradicted the latest Treasury Department Regulations on the subject. For these reasons the Ninth Circuit affirmed the ruling of the lower court that the Association was taxable as a corporation.

It is important to note that the court of appeals saw fit to address itself to the relation between state criteria and federal standards. The court’s admonition was:

[I]t would introduce an anarchic element in federal taxation if we determined the nature of associations by State criteria rather than by special criteria sanctioned by the tax law, the regulations and the courts. It would destroy the uniformity so essential to a federal tax system—a uniformity which calls for equal treatment of taxpayers, no matter in what State their activities are carried on. For it would mean that tax incidences as to taxpayers in the same category would be determined differently according to the law of the State of residence.

The Treasury Department refused to follow the Kintner decision and took the position instead that it would not recognize a corporation formed by doctors in order to qualify for the benefits of an employee trust. Its holding as announced was this:

A group of doctors who adopt the form of an association in order to obtain the benefits of corporate status for purposes of section 401(a) of the Internal Revenue Code of

19. 82 F.2d 473 (7th Cir. 1936).
1954 is in substance a partnership for all purposes of the Internal Revenue Code. It follows that the doctor-members are employers and therefore not employees. The contrary position expressed in the case of United States v. Arthur R. Kintner, 216 F.2d 418, will not be accepted by the Internal Revenue Service as a precedent in the disposition of other cases involving similar fact situations.

This ruling was modified to some extent one year later when the Internal Revenue Service announced that it was altering its position with respect to classification for federal income tax purposes of organized groups of doctors practicing medicine. Referring to the ruling quoted above, the Internal Revenue stated that in the future its position would be that where an association has established a pension plan under section 401(a) of the Internal Revenue Code of 1954, that fact would be determinative of whether such organization would be classified as a partnership or an association taxable as a corporation. Henceforth, "the usual tests will be applied in determining whether a particular organization of doctors or other professional groups has more of the characteristics of a corporation than of a partnership."

However, the Treasury's position again came under attack by the courts in 1959 when the United States District Court for the Northern District of Texas ruled that an association of physicians was to be treated as a corporation for tax purposes. Dr. Sidney Galt and several other physicians had organized an association in 1954 which had articles and bylaws similar to those of a corporation. The association was to endure for 35 years and was to be governed by a board of directors and an executive committee. Salaries were fixed by the committee, and the association paid social security and withholding taxes of the member-doctors, in addition to paying income tax on its own earnings at federal corporate tax rates. All of this was done despite the fact that Texas did not permit corporations to practice medicine. The court held that the lack of legislative approval did not preclude the organization of an association of doctors with terms similar to those of a corporation in a manner to render it taxable as though it were a corporation. Thus, the member-doctors who had formed the association were not taxable as partners. The decision in Kintner was not cited by the court, since Chief Judge Davidson felt the case

24. Id.
could be decided on principles of natural justice. However, in a postscript, it was noted that the court's attention had been called to an article discussing Kintner and the court found that decision "to be very much in harmony with its views." 27

III. THE KINTNER REGULATIONS

After the Galt decision, the Treasury Department was forced to take a more definitive stand than it had immediately following the Kintner decision. On December 23, 1959, within six months of Galt, the Treasury Department published notice of proposed rule-making with respect to the Regulations under chapter 79 of the Internal Revenue Code of 1954, relating to definitions. The Regulations were adopted and approved on November 15, 1960. 28

A study of the new Regulations indicates that the purpose of the revision was to prescribe detailed tests to be applied in determining whether an association was to be taxed as a corporation for tax years beginning after 1960. 29 The issuance of the tightened Regulations was without precedent, since the statutory provision 30 taxing associations as corporations had remained unchanged since 1917, and the new Regulations were announced unaccompanied by a change in the Act. The new provisions embodied the essential elements of the tests and standards prescribed by the Supreme Court in Morrissey, 31 and were intended to bar corporate treatment of unincorporated professional associations. The formula again was a purely arithmetical one—whether an unincorporated organization had more corporate characteristics than noncorporate characteristics. If it did, then it would more closely resemble a corporation and would be so classified. Characteristics common to the two types of organizations between which a choice must be made were not to be considered. In case the characteristics considered should result in a deadlock, the ruling would be that the organization was not an association.

It would seem that the approach of the 1960 Regulations, which failed to differentiate between the relative weight and importance of corporate attributes in the light of an organization's particular

27. Id. at 362.
28. Treas. Reg. 79 §§ 301.7701-1(a)-(c), -2(a)-(g), T.D. 6503, 1960-2 CUM. BULL. 409. These Regulations superseded paragraph 22 of T.D. 6118. See Appendix, § C infra at 131-41 for the pertinent changes made by this Treasury Decision.
30. INT. REV. CODE of 1954, § 7701(a) (3).
functions, might avoid some of the litigation that had occurred in
the past. However, in borderline cases courts might be hesitant to
apply the test as being too mechanical to do full justice to the
merits. A question of “resemblance” is not one of mathematics.

It should be noted that by the new Regulations, 32 the Treasury
made it very difficult for associations to meet the tests demanded.
As for the years previous to 1960, in which the Treasury Department
refused to recognize such “corporations,” the Treasury has taken a
very liberal attitude and has chosen not to dispute corporate treat-
ment by any organization which filed corporate returns for those
years. 33 By following such a policy, the Treasury Department
seemed to be attempting to avoid a direct confrontation with the
issue of the tax status of various professional associations. Obvi-
ously feeling that the newer and stricter “Kintner Regulations” (so-
called because of the decision that necessitated the new Regula-
tions) would provide a satisfactory solution to the perplexing at-
tacks on their Regulations, the Treasury chose not to trouble the
pre-1961 “Kintners” and “Gaits.”

However, the reaction to the revised Regulations of 1960 was
soon to be apparent. Since a strict interpretation of the original
“Kinter Regulations” would have made it impossible for associa-
tions of professional persons to qualify in the 38 states which had
in force the Uniform Partnership Act, 34 state legislatures began to
adopt new statutes and amend old laws to permit professional per-
sons to form organizations which would be able to meet the require-
ments of the Regulations. By the end of 1961, numerous states had
passed broad professional corporation acts. Several other states en-
acted professional corporation acts which were limited to specific-
ally enumerated professions. In addition, ten states, by new laws
or amendments to existing acts, permitted the formation of profes-

32. Treas. Reg. 79 § 301.7701-2(a)-(g) (1960). These provisions are
enumerated in the Appendix, § C infra at 132-41.
at 133.
34. A general partnership subject to a statute following the pattern of
the Uniform Partnership Act has no centralized management because the
act of any partner within the scope of the partnership business binds all
the partners, and a centralizing agreement does not bind an outsider who
has no notice of it. As to limited partnerships formed pursuant to statutes
similar to the Uniform Limited Partnership Act, generally there is cen-
tralized management only if substantially all the interests in the partnership
are owned by the limited partners. For these reasons, partnerships would
have difficulty meeting the centralized management requirement of Treas.
Reg. 79 § 301.7701-2(3)(c) (1960). All states except Alabama, Connecticut,
Florida, Georgia, Hawaii, Iowa, Kansas, Louisiana, Maine, Mississippi, New
Hampshire, and Texas have adopted the Uniform Partnership Act.
professional associations which could qualify under the "Kintner Regulations."\textsuperscript{35}

The "Kintner Regulations," it must be kept in mind, apply the tests and standards of the Internal Revenue Code of 1954. However, the exact scope and meaning of the legal relationships which have been created by the formation of organizations and which must be examined in applying the tests and standards are those defined by the applicable local law.\textsuperscript{36} Thus, no matter what the local law might determine a particular organization to be, whether for tax purposes it is to be regarded as a trust, as an association, or as a partnership will depend on the tests established by the Code and Regulations. In order to apply the tests, moreover, it may be necessary to examine the rights and duties of the members of the organization among themselves and in their relation to outsiders. This examination must also be guided by the applicable local law. To this extent there may result an apparent lack of uniformity. A "trust" under the laws of one state may tax-wise be classified as an association, while a "trust" organized under the laws of another state may tax-wise be considered to be a partnership or a trust. The lack of uniformity is on the surface only, though, because in reality the standards remain the same and uniform. They do go, however, to the substance of the legal relationships and disregard the label used by the laws of the state of formation. Therefore, even where state law permits the formation of professional service corporations, the Internal Revenue Code of 1954 and the Treasury Regulations will in the end determine whether such an organization is to be considered a corporation for tax purposes.\textsuperscript{37}

The next case involving the issue of the tax status of professional service organizations was \textit{Foreman v. United States},\textsuperscript{38} decided in 1964, wherein the United States District Court for the Southern District of Florida ruled that a professional association which had been organized in June 1960 for the practice of medicine should be taxed as a corporation rather than as a partnership as the Commissioner had determined.\textsuperscript{39} The two member-doctors of the Boulevard Orthopedic Association performed all surgery jointly, and all patients were visited, examined, and treated by both physicians rather than being assigned to one doctor only.

\textsuperscript{36} Treas. Reg. § 301.7701-1(c) (1960). See Appendix, § C infra at 131-32.
\textsuperscript{37} Treas. Reg. § 301.7701-1(b) (1960). See Appendix, § C infra at 131.
\textsuperscript{39} See id. at 135-36.
Association was to continue perpetually, and beneficial interests were transferable. The court said that the Association met three of the Morrissey tests, namely centralized management, continuity of life, and transferability of interests. In fact it was the court's opinion that these first three criteria were met "more strongly than in either the Kintner or Galt cases." Therefore, the court concluded that the Association more closely resembled a corporation, notwithstanding that physicians could not at that time form corporations for the practice of medicine under Florida law.

The impact of this decision is not as important as it might at first seem, since the tax return that was contested was for the fiscal year from June 1, 1960 to March 31, 1961. Thus, the case was not decided under the new 1960 Regulations which took effect beginning in 1961, nor under the Florida Professional Corporation Act. However, the decision was made in reliance upon the Kintner and Galt decisions, and for that reason, the Foreman holding is noteworthy. Moreover, the decision adds some weight to the decision of the Internal Revenue not to dispute corporate treatment of organizations which filed corporate returns for years prior to 1961.

IV. THE AMENDED KINTNER REGULATIONS

The next important step in the development of this area came on February 2, 1964 when amendments to the Regulations under section 7701 of the Internal Revenue Code of 1954 were adopted. These amendments, relating to the tax treatment of professional service corporations, associations, trusts, and other organizations, had been proposed on December 17, 1963, presumably to counteract the various statutes according corporate or quasi-corporate status to professional organizations. An examination of the 1965 amendments will demonstrate that section 301.7701-1 was altered by revising subsection (c), which deals with the effect of local law. The effect of the language which was added to that subsection was to take away from local law the importance it had enjoyed in the classification of professional service organizations. In addition to this revision, example (1) of section 301.7701-2 (g) was deleted, because it contained a hypothetical factual situation strongly similar to the factual situation in Galt v. United States. The most radical change

40. Id. at 136.
41. See id.
in the Regulations was the addition of subsection (h) to section 301.7701-2. This provision sought to impose rigorous requirements upon professional service organizations attempting to qualify as "corporations" for federal income tax purposes. In fact paragraphs (1)-(5) of subsection (h) practically nullify for professional associations the possibility of qualification, by pointing out in each instance that the special provisions governing professional corporations will generally prevent such associations from having the characteristics required in subsection (h).\footnote{Treas. Reg. § 301.7701-2(h) (1965). See Appendix, § E infra at 145-48.}

The effect of subsection (h), when considered together with the more stringent attitude toward local law and state "labeling" contained in paragraph (c) of Regulation 301.7701-2, indicates that it was the Treasury Department's purpose to set up tightened standards for corporate tax treatment of professional service organizations. The 1965 amendments have therefore resulted in a sharp difference between the tax treatment of quasi-corporate professional service organizations and other types of organizations with similar characteristics.

Because the adoption of the new Regulations presented problems as to the status of organizations that had sought to qualify as corporations for federal tax purposes prior to February 2, 1965, the Treasury Department once again created an amnesty period, which extended from the beginning of 1961 to December 31, 1964. It was determined that a corporation organized as a professional corporation under state law would be treated as a corporation for tax purposes beginning in 1961 and ending in 1965, for each year for which the corporation had filed timely corporate tax returns.

The initial attack on the revised 1965 Regulations came in August 1967, when the United States District Court for the District of Colorado held the Kintner Regulations as revised invalid.\footnote{Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967).} It was decided in Empey v. United States\footnote{Id.} that the Drexler and Wald Professional Company, a group of lawyers incorporated under the laws of the State of Colorado\footnote{COLO. REV. STAT. § 31 (1963).} and under the sanction of the Colorado Supreme Court,\footnote{On December 5, 1961 the Colorado Supreme Court, at the request of the Colorado Bar Association, departed from four hundred years of Anglo-American legal history and tradition and issued Rule No. 231, Colo. R. Civ. P., which permitted corporations to practice law in Colorado. See Bye & Young, Law Firm Incorporation in Colorado, 34 Rocky Mt. L. Rev. 427 (1962).} was taxable as a corporation and not as a partnership for federal tax purposes. The court applied the
Morrissey standards and determined that the organization satisfied the requirements thereof: There were associates; the corporation had been organized to carry on the practice of law for profit and to divide the gains; and it had continuity of life. Moreover, lawful authority and management of the corporation was vested in its directors and officers. The nature of shareholder liability was more similar to that of a corporate shareholder than to that of a partner, and while shareholder interests could be transferred only to lawyers actively engaged in the practice of law in the offices of the corporation or for the corporation, ownership interests could be transferred without destroying the organization.49 The court concluded that the Drexler and Wald Professional Company had all the corporate characteristics of the associations in Pelton50 and Kintner,51 as determined by the Morrissey52 test, and therefore that Drexler and Wald was an incorporated organization.53

However, the court felt that the most decisive factor in ruling for the taxpayer was the invalidity of section 301.7701-2 of the Treasury Regulations. In reaching its decision, the court considered the statutory definitions of partnership and corporation found in section 7701(a) of the Internal Revenue Code of 1954,54 and concluded that an incorporated organization is excluded by the express terminology of that section from being classified as a partnership, and that the definition of "partnership" refers only to "unincorporated" organizations.55 Even if the partnership definition had permitted the inclusion of incorporated organizations, neither the statute nor the case law supported the Treasury's position that organizations of professional men must be taxed as partnerships and not as corporations. Relying on Pelton, Kintner, and Galt as authority, the court concluded that the Treasury Regulations were inconsistent with the statute and the judicial construction thereof and accordingly were invalid and unenforceable.56 Moreover, even if they were assumed to be valid, the Drexler and Wald Professional Company satisfied all of the requirements necessary for taxation as a corporation.

50. Pelton v. Commissioner, 82 F.2d 473 (7th Cir. 1936).
53. This was the first case decided under Int. Rev. Code of 1954, § 7701 and Treas. Reg. § 301.7701 which dealt with organizations lawfully incorporated under state law.
56. Id. at 853.
Several months later, in February 1968, the United States District Court for the Northern District of Ohio was faced with a similar case. This time the situation involved a group of physicians known as Doctors Hill and Thomas Company, which was duly authorized and licensed as a professional association under the Ohio Revised Code. The plaintiff, one of 14 medical doctors employed by the company to provide radiological services to hospitals and individuals, was found by the Commissioner to be taxable as a partner and not as an employee-stockholder. The plaintiff appealed, presenting the district court with the question whether the organization qualified as a corporation under the Treasury Regulations. In reaching its decision, the court concerned itself almost exclusively with an examination of section 301.7701-2(h), the addition supplied by the 1965 amendments. This was the first direct examination of subsection (h). Empey v. United States had been based upon the contradiction between the Treasury Regulations' provision that an incorporated organization could be classified as a partnership and the express prohibition in the statute of such treatment of incorporated organizations.

The court felt that section 301.7701-2 could be divided into two distinct parts. Subsections (a)-(g), dealing generally with the standards and qualifications which must be met by organizations striving for tax treatment as corporations, form one part. Contained in these subsections are the four principal tests, basically the same as those first enumerated in Morrissey: limited liability, free transferability of interests, continuity of life, and centralization of management.

Turning its attention then to subsection (h), which comprises the second part and was the product of the 1965 revision, the court found the subsection to be reserved for professional service organizations alone. Basically, the same four tests are incorporated to determine whether a professional association is a corporation or a partnership for tax purposes. However, only professional service enterprises are subject to subsection (h), while other organizations which desire corporate tax treatment need only satisfy the general requirements enumerated in subsections (a)-(g). The court, after considering this, agreed with the Treasury's position that Doctors Hill and Thomas Company would be taxed as a partnership if

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section 301.7701-2(h) were to be applied. But the court went further.

The court thought that subsection (h) was invalid because its effect was to set up more stringent standards for corporate tax treatment of professional service organizations than for other kinds of organizations, and concluded that there was no support for this discrimination either in the statute or in judicial precedent. Nor could the court find any factual or legal characteristics which would justify different tax treatment of closely held professional service organizations, on the one hand, and closely held nonprofessional service organizations on the other. The court cited the Foreman decision for the statement that:

The fallacy [of the Treasury’s] argument is readily apparent when one considers the large number of corporations presently existing in our economy whose primary income is earned solely from the personal service of employees. The corporate tax status of businesses engaged in advertising or promotion, investigation, sales, contract janitorial or secretarial service, to name a few, has not been seriously questioned to this court’s knowledge.

Accordingly, the court held that section 301.7701-2(h) was invalid and would not be given effect. In short the court felt that the Regulation was an instance of administrative overreaching.

Five months after O’Neil v. United States was handed down in Ohio, the United States District Court for the Southern District of Florida, in Kurzner v. United States, was called upon for a decision upon the validity of subsection (h). The court found itself in agreement with the decisions in Empey and O’Neil, and therefore it too held that subsection (h) was invalid.

The circumstances in Kurzner did not vary much from those in O’Neil. The taxpayer was a licensed physician and an employee of the Gregory Orthopedic Associates, P.A. (hereinafter referred to as G.O.A.P.A.), an enterprise duly incorporated pursuant to the Florida Professional Service Corporation Act. Since its founding in September 1961, G.O.A.P.A. had operated as a corporation in the fullest sense. In fact, in applying the tests set out in the

62. Id. at 364.
64. 281 F. Supp. at 364.
65. Id.
68. Id. at 844.
Morrissey decision, the court found that the case at bar, when so analyzed, presented a stronger case for corporate tax status than was presented in Kintner, Galt, or Foreman. The charter of G.O.A.P.A. provided for perpetual existence, and its stockholders, by virtue of the provisions of Chapter 621.13 of the Florida Statutes, had sharply limited liability, which differed from the liability of stockholders of other corporations only in that each G.O.A.P.A. stockholder was personally liable for negligent or wrongful acts performed by him or by any employee under his direct supervision or control. Shareholder liability in Kintner, Galt, and Foreman was unlimited. Moreover, the court in Kurzner found that the degree of centralization of management in G.O.A.P.A. was identical to that in Kintner, Galt, and Foreman, since in each there was either an executive committee, a board of directors, or a board of governors that managed the affairs of the associates. Stock in G.O.A.P.A. was transferable, but only to another licensed physician and only with the consent of the majority of the shareholders, a limitation upon transferability similar to that found in Galt and Foreman. In Kintner the interests of members were nonassignable. Accordingly, the court found that the limitation upon stock ownership did not affect the transferability of interests. Because of the presence of the foregoing characteristics, the court found that the organization more closely resembled a corporation than a partnership.

However, the court went deeper into its examination of the Regulations after determining that the requirements of section 301.7701-2(a)-(g) were satisfied, and turned to an analysis of section 7701(a) of the Internal Revenue Code of 1954. There it found the same contradiction between the Code and the Regulations that the court in Empey had found, i.e., that the definition of partnership in Code section 7701(a) excluded any incorporated organization, while the Regulation in section 301.7701-2(h) classified an incorporated organization as a partnership if it failed to satisfy the requirements therein. From a reading of the statute, it appeared obvious to the court that G.O.A.P.A., having validly incorporated under Florida law, was a corporation. Moreover, according to the express terms of Code section 7701(a), G.O.A.P.A. could not constitute a partnership since such an entity must be an "unincorporated body." While normally a court will sustain Treasury Department Regulations, sustention is only required where the Regulations are

70. 286 F. Supp. at 845.
71. Id.
72. Id. at 844.
73. INT. REV. CODE of 1954, § 7701(a) (2).
reasonable and consistent with the revenue statutes.\textsuperscript{74} It is proper for courts to consider the wisdom of a Treasury Regulation, especially where, as in the case at bar, the subject Regulation has not been issued contemporaneously with the promulgation of the Code provision which it seeks to interpret. The court accordingly found that the inconsistency between the Code and the Regulation supported its finding that subsection (h) was unreasonable, and therefore could not be sustained.

A further basis for the court's decision in \textit{Kurzner} was similar to the rationale upon which the \textit{O'Neil} case was decided. Addressing itself to the discriminatory nature of subsection (h), the court said:

It cannot be doubted that except for the most unusual circumstances, these criteria preclude all professional service organizations from achieving corporate tax status. One need only compare Section 301.7701-2(a)-(g) to perceive this phenomenon. It at once becomes apparent that a dual set of criteria exists. One set is for the non-professional organization. The other and much stricter set of criteria is for the professional service organization. There is no support for this discrimination either in the cases or elsewhere. There is no factual or legal characteristic which would justify different tax treatment of closely held professional service organizations, on the one hand, and closely held non-professional service organizations, on the other hand.\textsuperscript{75}

The decision in \textit{Kurzner} set the stage for \textit{Holder v. United States},\textsuperscript{76} decided only two weeks later. In \textit{Holder} the United States District Court for the Northern District of Georgia based its decision upon an analysis of the Regulation similar to the approach adopted in \textit{Empey},\textsuperscript{77} \textit{O'Neil},\textsuperscript{78} and \textit{Kurzner},\textsuperscript{79} and, as had the courts in those decisions, found section 301.7701-2(h) of the Treasury Regulations to be invalid. Once again a group of medical doctors had changed the form of their practice from a partnership to a professional association duly registered to practice medicine, this time under the laws of the State of Georgia.\textsuperscript{80} The members of Clark-

\begin{footnotesize}
\begin{enumerate}
\item 286 F. Supp. at 844.
\item In 1961 the Georgia Professional Association Act, GA. CODE ANN. § 84-43 (Supp. 1967) was enacted. The court in \textit{Holder} found that the text of this act was virtually identical to the provisions of the Ohio Pro-
\end{enumerate}
\end{footnotesize}
Holder Clinic Professional Association adopted bylaws and elected a board of governors to achieve their purpose of making management more efficient than it had been under the partnership form. A profit-sharing plan and trust agreement were approved and set up. The Association had, since its first days, paid all state incorporation license taxes and corporate income taxes. It also paid social security taxes and collected federal withholding taxes for its employees, just as any other domestic corporation would. In addition the articles of the Association provided that the organization would not be terminated, dissolved, or in any similar manner affected by the death or incompetency of a member or by the happening of any other event which, under the laws of the State of Georgia, would otherwise work the dissolution of the organization. Therefore, the court found that the duration of the Association was to be perpetual.81

More important, the characteristics of limited liability82 and transferability of interests83 were provided for in the articles. The court found that the tests established in Morrissey were met, and therefore that the Association was virtually identical with the clinic approved for taxation as a corporation in example (1) of section 301.7701-2(g) which had been deleted in the 1965 amendments because of the Galt decision.84

Turning its attention to subsection (h),85 which it felt had been added because of the setbacks suffered by the Treasury Department in Galt and Foreman, the court stated that it was of the opinion that the Treasury Department was trying to accomplish by subsection (h) what it had failed to accomplish in litigation. The Treasury’s argument in the Foreman case, for instance, was simply that physicians could not legally form a corporation for the practice of medicine in the State of Florida. This argument, having been rejected by the courts, was simply rephrased and incorporated into new subsection (h), to the effect that a professional association could not be identical to a corporation.86 However, the court noted that, as stated in Morrissey87 and as demonstrated in sub-

81. 289 F. Supp. at 164.
82. This was determined after an examination of the section of the Georgia Professional Association Act, dealing with limited liability, GA. CODE ANN. § 84-307 (Supp. 1967).
83. This was determined after examination of the provision of the Georgia Professional Association Act dealing with transferability of interests, GA. CODE ANN. § 84-4310 (Supp. 1967).
86. 289 F. Supp. at 165.
sequent cases, it was resemblance and not identity which is controlling. The court reasoned that since the proposition that a professional association must be identical to a corporation had been rejected by the courts, a new pronouncement of this same proposition in the form of an administrative regulation, without any judicial or legislative sanction, could not be given weight. Moreover, the court felt that weight should be given to the fact that the prior Regulations, in accord with settled judicial construction and congressional intent, had been reinforced by repeated re-enactments of the relevant Code provisions, which in effect had approved the prior administrative interpretation sought now to be contradicted. Moreover, the court found that subsection (h) of the Regulations was contrary to the legislative intention evidenced by the statutory definitions contained in the Code for “partnership” and “corporation.” These definitions had remained unchanged for 35 and 49 years, respectively.

Persuaded by the foregoing considerations and by the decisions in previous cases, the court stated, with reference to the 1965 Treasury Regulations:

The criteria of taxability as a corporation have been set out and defined by the courts; a redefinition of these criteria by the Treasury Department which emasculates their meaning, cannot be dispositive of the question.

Under either the standards set out in existing case law or the application of section 301.7701-2(a)-(g), the court could see no alternative to holding that the Association was taxable as a corporation within the meaning of section 7702(a)(3) of the Internal Revenue Code. In so ruling, the Holder court held subsection (h) to be invalid.

V. CONCLUSION

It should be noted that there is no reason to believe that the criticisms of subsection (h) will be limited to cases involving the formation of professional associations under state incorporation or association statutes. A distinction should not be drawn between cases which arise in states having professional incorporation stat-

89. 289 F. Supp. at 165.
90. Id.
91. Id.
utes and cases which might arise in states without such statutes. It is important to remember that there were no such statutes at the time when *Pelton*,92 *Kintner*,93 *Galt*,94 and *Foreman*95 were decided. Since that time, the only real changes in the Regulations have been those which relegated the application of local law in the determination of tax status to a position of lesser importance96 and the adoption of subsection (h),97 which was aimed at preventing professional service associations from qualifying as corporations for tax purposes. It would seem that subsection (c), which made local law and its determinations of little importance in the classification of such organizations, would enhance the chances of professional associations to qualify for corporate tax status even in the absence of state incorporation statutes in their jurisdictions. Under the terms of subsection (c), the label put on an organization is not determinative of its tax status. If the court reviewing a case in which local law did not provide for professional service corporations were to apply the *Morrissey* criteria set forth in sections 301.7701-2(a)-(g) of the Treasury Regulations and find that the organization under investigation meets these tests, then this determination would dictate the decision, and not local law and the terminology which it uses. True, local law still determines the relationships between parties to the organizations among themselves and with outsiders, and these relationships are important under the *Morrissey* criteria. But the fact that an enterprise is organized as a limited partnership, trust, or association under local law is no longer important if the *Morrissey* standards are met. Therefore, it would seem that any organization able to satisfy the requirements of section 301.7701-2(a)-(g) would be deemed to have attained corporate tax status.

In view of the decisions of the courts in *Empey*,98 *O'Neil*,99 *Kurzner*,100 and *Holder*,101 it would seem that the Treasury Department's latest attempt to resolve the long controversy over the tax status of quasi-corporate professional service associations has failed to achieve its purpose. Subsection (h) has been tested four

92. *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936).
times, and four times it has been found invalid. The grounds upon which the decisions rest seem to be unquestionable. Where an organization has all of the attributes of a corporation, there would appear to be no rational basis for treating it otherwise than as a corporation for tax purposes. Furthermore, where an organization has many, but not all of the attributes of a corporation, so that it more closely resembles a corporation than any other form of enterprise, it too should be treated as a corporation for tax purposes. The difficulty has been in determining the point at which a non-corporation becomes a corporation. The courts have resolved this difficulty by applying the *Morrissey* test, a solution which the Treasury Department has thus far been unable to accept. For the present, however, since there appears to be no sound basis upon which the present Regulations can be upheld, it would seem that the courts will continue to disregard subsection (h) and determine tax treatment of professional associations upon the *Morrissey* criteria. It is now up to the Treasury Department to prescribe a nondiscriminatory alternative.

*Michael T. McKim '69*

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A. The pertinent portions of the Internal Revenue Code of 1939 are as follows:

Section 3797. (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) **PERSON.**—The term “person” shall be construed to mean and include an individual, a trust, estate, partnership, company, or corporation.

(2) **PARTNERSHIP AND PARTNER.**—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; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization. A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

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

B. The following Regulations were in existence at the time of United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), and comprise sections 29.3797-1, -2, -4 of 26 C.F.R., part 29 (1941).

Reg. 118, § 39.3797-1. **Classification of taxables.** For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. See § 39.2797-3. The term “partnership” is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. See § 39.3797-4. The term “corporation” is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. See §§ 39.3797-2 and 39.3797-4. See section 191 and the regulations thereunder, for recognition as a partner of any person who owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. The definitions, terms, and classifications, as set forth in section 3797, shall have the same
respective meaning and scope in the regulations in this part.

Reg. 118, § 39.3797-2. **Association.** The term “association” is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a “business” trust, a “Massachusetts” trust, a “common law” trust, an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership. An “investment” trust of the type commonly known as a management trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders. See Commissioner v. North American Bond Trust, 122 F.2d 545, cert. denied 314 U.S. 701. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

Reg. 118, § 39.3797-4. **Partnerships.** The Internal Revenue Code provides its own concept of a partnership. Under the term “partnership” it includes not only a partnership as known at common law, but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. On the other hand, the Code classifies under the term “corporation” an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation. As to the characteristics of an association, see also §§ 39.3797-2 and 39.3797-3. See section 191 and the regulations thereunder, for treatment as a partner of any person who owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.
C. The following Regulations were promulgated by the Treasury Department in 1960 in T.D. 6503 in the hope that the result reached in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954) would be prevented. The Regulations are commonly referred to as the "Kintner Regulations" because of that case.

Reg. § 301.7701-1. Classification of Organizations for Tax Purposes.—(a) *Person.*—The term "person" includes an individual, a corporation, a partnership, a trust or estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization or group. Such term also includes a guardian, committee, trustee, executor, administrator, trustee in bankruptcy, receiver, assignee for the benefit of creditors, conservator, or any person acting in a fiduciary capacity.

(b) *Standards.*—The Internal Revenue Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification in which an organization belongs (whether it is an association, a partnership, a trust, or other taxable entity) are determined under the Internal Revenue Code. Sections 301.7701-2 through 301.7701-4 set forth these tests, or standards, which are to be applied in determining whether an organization is (1) an association (see § 301.7701-2), (2) a partnership (see § 301.7701-3), or (3) a trust (see § 301.7701-4).

(c) *Effect of local law.*—As indicated in paragraph (b) of this section, the classes into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code. Thus, a particular organization might be classified as a trust under the law of one State and a corporation under the law of another State. However, for purposes of the Internal Revenue Code, this organization would be uniformly classed as a trust, an association (and, therefore, taxable as a corporation), or some other entity, depending upon its nature under the classification standards of the Internal Revenue Code. Similarly, the term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. See § 1.761-1 of this chapter (Income Tax Regulations) and § 301.7701-3. The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, and an insurance company. Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in
determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.

Reg. § 301.7701-2. Associations.—(a) Characteristics of corporations.—(1) 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. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These 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. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. In addition to the major characteristics set forth in this subparagraph, other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See Morrissey et al v. Commissioner (1935) 296 U.S. 344 [Ct. D. 1064, C.B. XV-I, 264 (1936)].

(2) Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of in-
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terests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

(3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association. Although the limited partnership also has associates and an objective to carry on business and divide the gains therefrom, these characteristics are not considered because they are common to both corporations and partnerships.

(4) The rules of this section and §§ 301.7701-3 and 301.7701-4 are applicable only to taxable years beginning after December 31, 1960. However, for any taxable year beginning after December 31, 1960, but before October 1, 1961, any amendment of the agreement establishing the organization will, in the case of an organization in existence on November 17, 1960, be treated for purposes of determining the classification of the organization as being in effect as of the beginning of such taxable year (i) if the amendment of the agreement is made before October 1, 1961, and (ii) if the amendment results in the classification of the organization under the rules of this section and §§ 301.7701-1, 301.7701-3, and 301.7701-4 in the same manner as the organization was classified for tax purposes on November 17, 1960.

(b) Continuity of life.—(1) An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the
organization, continuity of life does not exist. If the retire-
ment, death, or insanity of a general partner of a limited
partnership causes a dissolution of the partnership, un-
less the remaining general partners agree to continue the
partnership, continuity of life does not exist. See Glensder

(2) For purposes of this paragraph, dissolution of an
organization means an alteration of the identity of an
organization by reason of a change in the relationship be-
tween its members as determined under local law. For
example, since the resignation of a partner from a general
partnership destroys the mutual agency which exists be-
tween such partner and his copartners and thereby alters
the personal relation between the partners which consti-
tutes the identity of the partnership itself, the resignation
of a partner dissolves the partnership. A corporation, how-
ever, has a continuing identity which is detached from the
relationship between its stockholders. The death, insanity,
or bankruptcy of a shareholder or the sale of a share-
holder's interest has no effect upon the identity of the
corporation and, therefore, does not work a dissolution of
the organization. An agreement by which an organization
is established may provide that the business will be con-
tinued by the remaining members in the event of the death
or withdrawal of any member, but such agreement does
not establish continuity of life if under local law the death
or withdrawal of any member causes a dissolution of the
organization. Thus, there may be a dissolution of the or-
ganization and no continuity of life although the business
is continued by the remaining members.

(3) An agreement establishing an organization may
provide that the organization is to continue for a stated
period or until the completion of a stated undertaking or
such agreement may provide for the termination of the
organization at will or otherwise. In determining whether
any member has the power of dissolution, it will be neces-
sary to examine the agreement and to ascertain the effect
of such agreement under local law. For example, if the
agreement expressly provides that the organization can be
terminated by the will of any member, it is clear that the
organization lacks continuity of life. However, if the
agreement provides that the organization is to continue
for a stated period or until the completion of a stated
transaction, the organization has continuity of life if the
effect of the agreement is that no member has the power
to dissolve the organization in contravention of the agree-
ment. Nevertheless, if, notwithstanding such agreement,
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.

(c) Centralization of management.—(1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation. The effective operation of a business organization composed of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization, and therefore, centralized management is more likely to be found in such an organization than in a smaller organization.

(2) The persons who have such authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office. See Morrisey et al. v. Commissioner (1935) 296 U.S. 344 [Ct. D. 1064, C.B. XV-I, 264 (1936)]. Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

(3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

(4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or the trust by his acts. However, because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Usually, the act of any partner within the scope of the partnership business binds all the partners; and even if the partners agree among themselves that the powers of management shall be exclusively in a
selected few, this agreement will be ineffective as against an outsider who had no notice of it. In addition, limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners.

(d) Limited liability.—(1) An organization has the corporate characteristics of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. A member of the organization who is personally liable for the obligations of the organization may make an agreement under which another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for any such liability. However, if under local law the member remains liable to such creditors notwithstanding such agreement, there exists personal liability with respect to such member. In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner. Similarly, in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph.

(2) In the case of an organization formed as a limited partnership, personal liability does not exist, for purposes of this paragraph, with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a "dummy" acting as the agent of the limited partners. Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners. Also, if a corporation is a general partner, personal liability exists with respect to such general partner when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the limited partnership. A general partner may contribute his services, but no capital, to the organization, but if such general partner has substantial assets (other than his interest in the partnership), there exists personal liability. Furthermore, if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have
substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization. In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a “dummy” acting as the agent of the limited partners.

(e) Free transferability of interests.—(1) An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization. Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization. Furthermore, although the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.

(2) If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

(f) Cross reference.—See paragraph (b) of § 301.7701-3 for the application to limited partnerships of the rules relating to corporate characteristics.

(g) Examples.—The application of the rules described in this section may be illustrated by the following examples:

Example (1). A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any indi-
vidual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member shall cause the dissolution of the organization. Under the applicable local law, on the occurrence of such an event, no member has the power to dissolve the organization. The management of the clinic is vested exclusively in an executive committee of four members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Members of the clinic are personally liable for all debts of, or claims against, the clinic. Every member has the right to transfer his interest to a doctor who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While it does not have the corporate characteristics of limited liability, it does have the characteristics of centralized management, continuity of life, and a modified form of free transferability of interests. The organization will be classified as an association for all the purposes of the Internal Revenue Code.

Example (2). A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any individual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member shall cause the dissolution of the organization. However, under the applicable local law, a member who withdraws does have the power to dissolve the organization. While the agreement provides that the management of the clinic is to be vested exclusively in an executive committee of four members elected by all the members, this provision is ineffective as against outsiders who had no notice of it; and, therefore, the act of any member within the scope of the organization's business binds the organization insofar as such outsiders are concerned. While the agreement declares that each individual doctor alone is liable for acts of malpractice, members of the clinic are, nevertheless, personally liable for all debts of the clinic including claims based on malpractice. No member has the right, without the consent of all the other members, to transfer his interest to a doctor who is not a member of the clinic. The organization has associates and an objective to carry on business and divide the gains therefrom. However, it does not have
the corporate characteristics of continuity of life, centralized management, limited liability, and free transferability of interests. The organization will be classified as a partnership for all purposes of the Internal Revenue Code.

Example (3). A group of twenty-five lawyers forms an organization for the purpose of furnishing, for profit, legal services to the public. Their agreement provides that the organization will dissolve upon the death, insanity, bankruptcy, retirement, or expulsion of a member. While their agreement provides that the management of the organization is to be vested exclusively in an executive committee of five members elected by all the members, this provision is ineffective as against outsiders who had no notice of it; and, therefore, the act of any member within the scope of the organization's business binds the organization insofar as such outsiders are concerned. Members of the organization are personally liable for all debts, or claims against, the organization. No member has the right, without the consent of all the other members, to transfer his interest to a lawyer who is not a member of the organization. The organization has associates and an objective to carry on business and divide the gains therefrom. However, the four corporate characteristics of limited liability, centralized management, free transferability of interests, and continuity of life are absent in this case. The organization will be classified as a partnership for all purposes of the Internal Revenue Code.

Example (4). A group of twenty-five persons forms an organization for the purpose of engaging in real estate investment activities. Each member has the power to dissolve the organization at any time. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does have the characteristics of centralized management and a modified form of free transferability of interests, it does not have the corporate characteristics of continuity of life and limited liability. Under the circumstances presented, the organization will be classified as a partnership for all purposes of the Internal Revenue Code.

Example (5). A group of twenty-five persons forms
an organization for the purpose of engaging in real estate investment activities. Under their agreement, the organization is to have a life of twenty years, and under the applicable local law, no member has the power to dissolve the organization prior to the expiration of that period. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the corporate characteristic of limited liability, it does have continuity of life, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

Example (6). A group of twenty-five persons form an organization for purposes of engaging in real estate investment activities. Each member has the power to dissolve the organization at any time. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, the liability of each member for the obligations of the organization is limited to paid and subscribed capital. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the characteristic of continuity of life, it does have limited liability, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

Example (7). A group of twenty-five persons forms an organization for the purpose of investing in securities so as to educate the members in principles and techniques of investment practices and to share the income from such investments. While the agreement states that the organ-
ization will operate until terminated by a three-fourths vote of the total membership and will not terminate upon the withdrawal or death of any member, under the applicable local law, a member has the power to dissolve the organization at any time. The business of the organization is carried on by the members at regular monthly meetings and buy or sell action may be taken only when voted by a majority of the organization's membership present. Elected officers perform only ministerial functions such as presiding at meetings and carrying out the directions of the members. Members of the organization are personally liable for all debts of, or claims against the organization. No member may transfer his membership. The organization has associates and an objective to carry on business and divide the gains therefrom. However, the organization does not have the corporate characteristics of limited liability, free transferability of interests, continuity of life, and centralized management. The organization will be treated as a partnership for all purposes of the Internal Revenue Code.

Reg. § 301.7701-3. Partnerships.—(a) In general.—The term “partnership” is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, 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 a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

(b) Limited partnerships.—(1) In general.—An organization which qualifies as a limited partnership under State law may be classified for purposes of the Internal Revenue Code as an ordinary partnership or as an association. Such a limited partnership will be treated as an association if, applying the principles set forth in § 301.7701-2, the organization more nearly resembles a corporation than an ordinary partnership or other business entity.
(2) Examples.—The principles of this paragraph may be illustrated by the following examples:

Example (1). Three individuals form an organization which qualifies as a limited partnership under the laws of the State in which the organization was formed. The purpose of the organization is to acquire and operate various pieces of commercial and other investment property for profit. Each of the three individuals who are general partners invests $100,000 in the enterprise. Five million dollars of additional capital is raised through contributions of $100,000 or more by each of thirty limited partners. The general partners are personally capable of assuming a substantial part of the obligations to be incurred by the organization. While a limited partner may assign his right to receive a share of the profits and a return of his contribution, his assignee does not become a substituted limited partner except with the unanimous consent of the general partners. The life of the organization as stated in the certificate is 20 years, but the death, insanity, or retirement of a general partner prior to the expiration of the 20-year period will dissolve the organization. The general partners have exclusive authority to manage the affairs of the organization but can act only upon the unanimous consent of all of them. The organization has associates and an objective to carry on business and divide the gains therefrom, which characterize both partnerships and corporations. While the organization has the corporate characteristics of centralized management since substantially all of the interests in the organization are owned by the limited partners, it does not have the characteristics of continuity of life, free transferability of interests, or limited liability. The organization will be classified as a partnership for all purposes of the Internal Revenue Code.

Example (2). Three individuals form an organization which qualifies as a limited partnership under the laws of the State in which the organization was formed. The purpose of the organization is to acquire and operate various pieces of commercial and other investment property for profit. The certificate provides that the life of the organization is to be 40 years, unless a general partner dies, becomes insane, or retires during such period. On the occurrence of such death, insanity, or retirement, the remaining general partners may continue the business of the partnership for the balance of the 40-year period under a right so to do stated in the certificate. Each of the three individuals who is a general partner invests $50,000 in the enterprise and has means to satisfy the business obligations of the organization to a substantial extent. Five million dollars of additional capital is raised through the sale of freely transferable interests in amounts of $10,000 or less to limited partners. Nine hundred such interests are sold. The interests of the 900 limited partners are fully trans-
ferable, that is, a transferee acquires all the attributes of
the transferor's interest in the organization. The general
partners have exclusive control over management of the
business, their interests are not transferable, and their
liability for debts of the organization is not limited to their
capital contributions. The organization has associates and
an objective to carry on business and divide the gains
therefrom. It does not have the corporate characteristics
of limited liability and continuity of life. It has centralized
management, however, since the three general partners
exercise exclusive control over the management of the
business, and since substantially all of the interests in the
organization are owned by the limited partners. While
the interests of the general partners are not transferable,
the transferability test of an association is met since sub-
stantially all of the interests in the organization are repre-
sentated by transferable interests. The organization will
be classified as a partnership for all purposes of the In-
ternal Revenue Code.

(c) Partnership associations.—The laws of a number
of States provide for the formation of organizations com-
monly known as partnership associations. Such a part-
nership association will be treated as an association if, apply-
ning the principles set forth in § 301.7701-2 the organization
more nearly resembles a corporation than the other types
of business entities.

(d) Partner.—The term “partner" means a member of
a partnership.

D. The sections of the Internal Revenue Code of 1954 which are
pertinent to the discussion here are the same as they were under
the Internal Revenue Code of 1939. They are:

Section 7701. (a) When used in this title, where not other-
wise distinctly expressed or manifestly incompatible with
the intent thereof—

(1) PERSON.—The term “person" shall be construed
to mean and include an individual, a trust, estate, part-
nership, association, company or corporation.

(2) PARTNERSHIP AND PARTNER.—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; and the term
"partner" includes a member in such a syndicate, group,
pool, joint venture, or organization.

(3) CORPORATION.—The term “corporation" includes
associations, joint-stock companies, and insurance com-
panies.

E. Except for the following material, the Regulations remain the
same today as they were under the 1960 Regulations. The changes set forth below comprise the 1965 amendments and were announced in T.D. 6797 (1965).

**Paragraph 1.** Section 301.7701-1 is amended by revising paragraph (c) thereof to read as follows:

§ 301.7701-1. *Classification of Organizations for Tax Purposes.*

(c) *Effect of local law.*—As indicated in paragraph (b) of this section, the classes into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code. Thus, a particular organization might be classified as a trust under the law of one State and a corporation under the law of another State. However, for purposes of the Internal Revenue Code, this organization would be uniformly classed as a trust, an association (and, therefore, taxable as a corporation), or some other entity, depending upon its nature under the classification standards of the Internal Revenue Code. Similarly, the term “partnership” is not limited to the common-law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. See § 1.761-1 of this chapter (Income Tax Regulations) and § 301.7701-3. The term “corporation” is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, and an insurance company. Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization belongs, local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets. Nevertheless, the labels applied by local law to organizations, which may now or hereafter 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 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). The classification in which a professional service organization belongs is determined under the tests and standards set forth in §§
Paragraph 2. Section 301.7701-2 is amended by revising the heading of such section, by adding a new subparagraph (5) to paragraph (a), by striking out example (1) in paragraph (g), and by adding a new paragraph (h). These amended provisions read as follows:

Reg. § 301.7701-2. Associations, including Organizations Labeled "Corporations."

(a) Characteristics of corporations. * * *

(5) The rules of paragraph (h) of this section are applicable only to taxable years beginning after December 31, 1960. However, in the case of an organization formed as a partnership association, a business trust, an ordinary business corporation, or a professional service organization formed under a local law or regulatory rule specifically authorizing the formation of such organizations, the rules of paragraph (h) of this section shall not apply to any taxable year ending on or before December 31, 1964, if such organization made its return for any such taxable year, filed at or prior to the time (including extensions thereof) that the return for such taxable year was required to be filed, as if its income were subject to the tax imposed by section 11 of the Code (relating to tax imposed on corporations).

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(g) Examples. * * *

Example (1).—[Deleted.]

(h) Classification of professional service organizations.—(1) (i) A professional service organization is treated as a corporation (or as an association and, therefore, taxable as a corporation) only if it has sufficient corporate characteristics to be classifiable as a corporation under paragraph (a) of this section, rather than as a partnership or proprietorship. For purposes of determining the classification of an organization under these regulations, the term "professional service organization," as used in this paragraph, means an organization formed by one or more persons to engage in a business involving the performance of professional services for profit which under local law, may not be organized and operated in the form of an ordinary business corporation having the usual characteristics of such a corporation. Thus, even if a professional service organization is organized as an ordinary business corporation, this paragraph applies if such corporation is subject to local regulatory rules which deprive such corporation of the usual characteristics of an ordinary business corporation. This paragraph applies irrespective of whether an organization is labeled under local law as a
professional service corporation, a professional service association, a trust, or otherwise.

(ii) In determining whether a professional service organization has the major characteristics ordinarily found in a business corporation and whether any other significant factors are to be taken into account in classifying the organization, the special professional requirements of the profession engaged in by the members of the organization must be taken into consideration. Although such an organization may have associates and is engaged in business for profit, the relationships of the members of such an organization to each other as well as their relationships to employees, to clients, patients, or customers and to the public are inherently different from the relationships characteristic of an ordinary business corporation. In determining the nature of these relationships, consideration must be given to the law under which the organization is formed, the charter, articles of association, bylaws, or other documents relating to the formation of the organization, and all other facts and rules governing or pertaining to such relationships in the usual course of the practice of the profession of the participants.

(2) A professional service organization does not have continuity of life within the meaning of paragraph (b) of this section if the death, insanity, bankruptcy, retirement, resignation, expulsion, professional disqualification, or election to inconsistent public office of any member will (determined without regard to any agreement among the members) cause under local law the dissolution of the organization. A business corporation has a continuing identity as an entity which is not dependent upon a shareholder's active participation in any capacity in the production of the income of the corporation. Furthermore, the interest of a shareholder in an ordinary business corporation includes a right to share in the profits of the corporation, and such right is not legally dependent (determined without regard to any agreement among the shareholders) upon his participation in the production of the corporation's income. However, the interest of a member of a professional service organization generally is inextricably bound to the establishment and continuance of an employment relationship with the organization, and he cannot share in the profits of a professional service organization unless he also shares in the performance of the services rendered by the organization. For purposes of this paragraph, the term "employment relationship" is used to describe such active participation by the member and is not restricted to the common-law meaning of such term. 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. The continued existence of such a professional service organization is similar to that of a partnership formed under the Uniform Partnership Act, whose business continues pursuant to an agreement providing that the business will be continued by the remaining members after the withdrawal or death of a partner (see paragraph (b) of this section), and is essentially different from the continuity of life possessed by an ordinary business corporation. Consequently, such a professional service organization lacks continuity of life.

(3) In applying the rules of paragraph (c) of this section, relating to centralization of management, a professional service organization does not have centralization of management where the managers of a professional service organization under local law are not vested with the continuing exclusive authority to determine any one or more of the following matters: (i) The hiring and firing of professional members of the organization and its professional and lay employees, (ii) the compensation of the members and of such employees, (iii) the conditions of employment—such as working hours, vacation periods, and sick leave, (iv) the persons who will be accepted as clients or patients, (v) who will handle each individual case or matter, (vi) the professional policies and procedures to be followed in handling each individual case, (vii) the fees to be charged by the organization, (viii) the nature of the records to be kept, their use, and their disposition, and (ix) the times and amounts of distributions of the earnings of the organization to its members as such. 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. Instead, such measure of central control is no more than that existing in an ordinary large professional partnership which has one or more so-called managing partners and in which a member retains the traditional professional autonomy with respect to professional decisions and the traditional responsibility of a professional person to the client or patient. Such measure of central control is essentially different from the centralization of management existing in an ordinary business corporation. Therefore, centralization of management does not exist in such a professional service organization.
(4) A professional service organization has the corporate characteristic of limited liability within the meaning of paragraph (d) of this section only if the personal liability of its members, in their capacity as members of the organization, is no greater in any aspect than that of shareholder-employees of an ordinary business corporation. If under local law and the rules pertaining to professional practice, a mutual agency relationship, similar to that existing in an ordinary professional partnership, exists between the members of a professional service organization, such organization lacks the corporate characteristic of limited liability.

(5) (i) If the right of a member of a professional service organization to share in its profits is dependent upon the existence of an employment relationship between him and the organization, free transferability of interests within the meaning of paragraph (e) of this section exists only if the member, without the consent of other members, may transfer both the right to share in the profits of the organization and the right to an employment relationship with the organization.

(ii) The corporate characteristic of free transferability of interests exists in a modified form within the meaning of paragraph (e)(2) of this section when a shareholder in an ordinary business corporation can transfer his interest in such corporation only after having offered such interest to the other shareholders at its fair market value. In such a case, the so-called right of first refusal applies only to an interest which is a right to share in the profits, the assets, and the management of the enterprise. However, if the interest of a member of a professional service organization constitutes a right to share in the profits of the organization which is contingent upon and inseparable from the member's continuing employment relationship with the organization, and the transfer of such interest is subject to a right of first refusal, such interest is subject to a power in the other members of the organization to determine not only the individuals whom the organization is to employ, but also who may share with them in the profits of the organization. The possession by other members of the power to determine, in connection with the transfer of such an interest, whom the organization is to employ is so substantial a hindrance upon the free transferability of interests in the organization that such power precludes the existence of a modified form of free transferability of interests. Therefore, if a member of a professional service organization who possesses such an interest may transfer his interest to a qualified person who is not a member of the organization only after having first offered his interest to the other members of the organization at its fair market value, the corporate characteristic of free transferability of interests does not exist.