A BRIEF LOOK AT THE ADVANTAGES AND DISADVANTAGES OF PROFESSIONAL INCORPORATION

M. H. Weinberg*

INTRODUCTION

Corporations are rapidly becoming a more popular organizational vehicle for medical, dental, veterinary, and legal group practices. Even though a large majority of professionals continue to operate in partnership form, the trend seems to indicate a definite surge toward incorporation. Obviously, the prudent practitioner should study the advantages and disadvantages of incorporation, so as to avail himself of the most advantageous mode of business operation.

The corporate form of organization has become more prevalent for two basic reasons. First, the number of states permitting the incorporation of professional practices has increased dramatically in the last three years. In fact, with the passage of a Professional Service Corporation Act by Wyoming,¹ all fifty states now have on their books authority for professional persons to incorporate.²

Secondly, the Internal Revenue Service (Service) originally challenged professional corporations on the basis that they did not represent valid corporate entities. Taxpayers, however, were consistently successful in appealing such cases³ and, as a result, the Service announced in August, 1969, that professional corporations would be recognized as valid entities for income tax purposes.⁴ Following this, in March of 1970, the Service issued a published revenue ruling which enumerated the states where professional corporation laws were acceptable.⁵ Eight revenue rulings followed, approving corporate status for associations, limited partnerships, limited liability companies, and professional service corporations.

* B.A., Creighton University; J.D., Creighton University School of Law; B.S., Creighton University; LL.M., New York University. Lecturer in Law, Creighton University School of Law; Professor, Business Law and Professional Corporations, University of Nebraska at Omaha. Former Auditor and Attorney for the Internal Revenue Service. Member of the Omaha, Nebraska and American Bar Associations.

and business trusts."

Although the Service conceded the prime issue of professional corporations, it did reserve the right to challenge them under special circumstances, such as in the case of Jerome J. Roubik. In that case, the parties continued to operate their business as they had before incorporation, using separate offices across town, distinct accounting records and separate staffs. The decision by the Tax Court upheld the Commissioner's contention that the incorporation was a mere sham, having no business purpose. This case has been followed in Jack E. Morrison, and thus it is imperative that, should incorporation be deemed advantageous, the form, as well as the substance, must be adopted.

Bearing in mind that professional corporations are now allowed by the states and recognized by the Service, the professional is faced with the problem of determining the best form of organization in which to practice. In making this decision, the practitioner and his advisors must consider not only the tax consequences of incorporation, but also the business and client-related implications thereof.

NON-TAX ADVANTAGES

The corporate form provides for a continuity of life that is not available in partnerships, which usually must terminate when a partner withdraws or dies. Also, stock in a corporation is readily transferable, whereas a partnership interest can be transferred only with the permission of one's fellow partners. Further, a corporation is the only business form which allows centralized, professional management, separate and apart from the shareholders. In addition, a corporation provides tax certainty in its operation, as the statutes on corporations are definite and certain. The professional corporation also provides limited liability as regards contract obligations and personal injury not connected to professional service. In a partnership, however, every partner is jointly and severally liable for a personal injury judgment against either a partner or an associate. Furthermore, this liability is not limited to his partnership interest, but extends to all his non-exempt assets.

6. Rev. Rul. 72-121, 1972 INT. REV. BULL. No. 11, at 18 (business trust); Rev. Rul. 72-120, 1972 INT. REV. BULL. No. 11 at 17 (business trust); Rev. Rul. 72-75, INT. REV. BULL. No. 8 at 10 (business trust); Rev. Rul. 574, 1971-2 CUM. BULL. 432 (associations); Rev. 434, 1971-2 CUM. BULL. 430 (limited partnerships); Rev. Rul. 277, 71-1 CUM. BULL. 422 (association); Rev. Rul. 629, 1970-2 CUM. BULL. 228 (association.)
8. 54 T.C. 758 (1970).
TAX ADVANTAGES

Before beginning a discussion of the tax considerations, we should first consider, from a tax viewpoint, why a substantial difference exists between the partnership and the corporate form of doing business. Simply stated, the Internal Revenue Code, which represents legislation enacted by the Congress of the United States, provides certain benefits to employees of corporations and also to the granting corporation. Non-owner employees of partnerships are generally granted similar tax preferences. Unfortunately, the draftsmen of the tax law did not feel that owner-employees, i.e., partners, should be entitled to the same benefits as non-owner employees. As an example, before the Code was changed permitting owner-employees to participate in qualified tax-exempt pension and annuity arrangements, known as Keogh (HR-10) Plans, partners were not permitted to benefit from otherwise qualified plans. However, despite the adoption of the HR-10 legislation, Congress has left a wide disparity in the benefits of such plans when compared to similar corporate endeavors. The Keogh Plans will be discussed in greater detail later in the article.

The tax advantages given to corporations are (1) capital accumulation, (2) current expensing of otherwise non-deductible personal items, such as tax-deductible term life insurance for employees, tax-deductible major medical coverage and tax-deductible disability income insurance, and (3) long range profit shelters (pension and profit sharing plans). The net effect of these benefits can be seen to result in an increase in the net spendible income of the individual professional, as demonstrated by the following comparisons between a partnership and corporation, both filing a calendar year cash basis return for the year 1972.

13. Id.
14. The assumption is made that no items of tax preference are included in the individual, partnership or corporate income.
CAPITAL ACCUMULATION COMPARISON

OBJECTIVE: To accumulate $16,000 for the purchase of capital equipment by four professionals.

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Entity</th>
<th>Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300,000</td>
<td>Total Group Billings</td>
<td>$300,000</td>
</tr>
<tr>
<td>($100,000)</td>
<td>General Overhead</td>
<td>($100,000)</td>
</tr>
<tr>
<td>($178,892)</td>
<td>Principals' Salaries</td>
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</tr>
<tr>
<td>$21,108</td>
<td>Profit</td>
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</tr>
<tr>
<td>(4,644)</td>
<td>Federal Income Tax</td>
<td>(0)</td>
</tr>
<tr>
<td>$16,464</td>
<td>Retained Capital *** Distributable</td>
<td>$200,000</td>
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<table>
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<tr>
<th>Individual</th>
<th>Salary *** Distributable</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>($)11,239*</td>
<td>Federal Income Tax</td>
<td>($13,712)*</td>
</tr>
<tr>
<td>(0)</td>
<td>Capital Contribution</td>
<td>($4,000)</td>
</tr>
<tr>
<td>$33,484</td>
<td></td>
<td>$32,288</td>
</tr>
</tbody>
</table>

Individual savings: $1,196 (33,484 - 32,288) / 4 Associates

Total group savings: $4,784

*Illustrations throughout assume five exemptions and $3,600 of itemized deductions.

The corporation may thus be a vehicle to aid the individual professional in lessening his tax burden. It is elementary that the first $25,000 of corporate income is subject to a very low 22 percent tax rate, though income earned by the corporation over $25,000 is taxed at 48 percent. Therefore, if a physician is in the 50% bracket, it is far better to have the first $25,000 taxed at the 22% level, since 78¢ on the dollar can then be reinvested, as opposed to 50¢ otherwise.

### Current Expense Comparison

**OBJECTIVE:** To pay premiums in the amount of $1,450 and $450 for health and term life insurance respectively, for four professionals.

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</thead>
<tbody>
<tr>
<td>$300,000</td>
<td>Total Group Billings</td>
<td>$300,000</td>
</tr>
<tr>
<td>($100,000)</td>
<td>General Overhead</td>
<td>($100,000)</td>
</tr>
<tr>
<td>( 5,800)</td>
<td>Health Insurance</td>
<td>( 0)</td>
</tr>
<tr>
<td>( 1,800)</td>
<td>Term Insurance</td>
<td>( 0)</td>
</tr>
<tr>
<td>($192,400)</td>
<td>Principals' Salaries</td>
<td>( 0)</td>
</tr>
<tr>
<td>0</td>
<td>Profit ** * Distributable</td>
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<tr>
<td>0</td>
<td>Federal Income Tax</td>
<td>( 0)</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Individual</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 48,100</td>
<td>Salary ** * Distributable</td>
</tr>
<tr>
<td>($12,800)</td>
<td>Federal Income Tax</td>
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<tr>
<td>( 0)</td>
<td>Health Insurance</td>
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<tr>
<td>( 0)</td>
<td>Term Insurance</td>
</tr>
<tr>
<td>$ 35,300</td>
<td>Spendible Income</td>
</tr>
</tbody>
</table>

**Individual savings:** $ 912 ($35,300 - $34,388)  
**Total group savings:** $3,648

The total yearly savings in example 2 are further enhanced when one realizes that the proceeds of the group term life insurance are not subject to income tax on the death of the shareholder-employee, nor to estate tax if the incidents of ownership are assigned at least three years before death. The Service has recognized such an assignment to be effective for the purpose of avoiding estate tax on group term life insurance. Also, under such insurance plans, the payments by the corporation of policy premiums are treated as corporate deductions without any compensation being recognized by the employee. In effect, then, medical and life insurance expenses will be paid with pre-tax, as opposed to post-tax dollars.

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16. *Id.* § 101.  
17. *Id.* §§ 2042 and 2035.  
19. Note 12 *supra.*  
Finally, a widow could receive a $5,000 tax-free death benefit from the corporation, and a certain amount of disability benefits can be excluded from income tax by an employee.

**LONG RANGE TAX SHELTER COMPARISON**

**OBJECTIVE**: To put aside $8,000 for each associate's family security and retirement.

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<tbody>
<tr>
<td>$300,000</td>
<td>Total Group Billings</td>
<td>$300,000</td>
</tr>
<tr>
<td>($100,000)</td>
<td>General Overhead</td>
<td>($100,000)</td>
</tr>
<tr>
<td>(32,000)</td>
<td>Qualified Plan</td>
<td>(0)</td>
</tr>
<tr>
<td>(168,000)</td>
<td>Principals' Salaries</td>
<td>(0)</td>
</tr>
<tr>
<td>0</td>
<td>Profit ** Distributable</td>
<td>$200,000</td>
</tr>
<tr>
<td>0</td>
<td>Federal Income Tax</td>
<td>0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>$42,000</td>
</tr>
<tr>
<td>($10,035)</td>
</tr>
<tr>
<td>(0)</td>
</tr>
<tr>
<td>$31,965</td>
</tr>
</tbody>
</table>

Individual savings: $3,677 \[= \frac{31,965 - 28,288}{4} \]

Total group savings: $14,708

Corporations may make temporary investments with the excess funds generated by this example. If these investments are made in dividend paying stock, the Code permits an 85 percent dividends received deduction. Thus, the corporation is subject only to tax on 15 percent of the dividend income received, making the maximum effective rate a mere 7.2 percent. An individual cannot take advantage of such a dividend deduction beyond $200 on a joint return.

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22. *id.* § 105.
24. 15%, the amount subject to tax, times 48%, the maximum corporate tax rate.
Operating as a partnership, the professional partners have only limited opportunities to defer taxable income, to be compared shortly. Concededly, such deferral can be extremely advantageous for an individual who is nearing retirement, and who can foresee years in which his taxable income will substantially decline. Because of the graduated tax rate schedule it is always preferable, if possible, to defer the recognition of salary income until after retirement, when earnings are naturally reduced.

KEOGH PLANS V. CORPORATE PLANS

Attention will now be directed toward comparing the allowable partnership plans with the similar corporate endeavors. However, only a broad overview is permitted due to the many nuances involved.26

On October 10, 1962, President Kennedy signed into law the Self-Employed Individuals Tax Retirement Act of 1962. The Act permits employers to establish retirement benefits for their employees by instigating annuity, profit sharing or pension plans.27 Further, it includes the self-employed taxpayer within the term “employee,” by acknowledging that realistically he is both the employer and the employee.

As a general rule, however, these HR-10 (Keogh) Plans are much less attractive than qualified corporate plans. And, even if the President’s proposal allowing increased contributions of $7,500, or 15 percent of earned income, were passed into law, the allowance would still not be as high as the deduction permitted under a corporate combination of plans, which can go as high as 30 percent of an individual’s annual salary.28 For a lawyer earning $60,000, this represents an additional accumulation of $9,000 a year. $9,000 per year for thirty years could provide, at five percent simple interest, a distribution of well over one-half million dollars.

Some additional comparisons are:

1. Under a corporate profit sharing plan a contribution equal to 15 percent of employee compensation can be made. Were the corporation to establish a pension plan in addition to a profit sharing plan, a maximum of 25 percent of an employee’s compensation may be contributed to his account. If a pension plan alone is used, the

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28. INT. REV. CODE of 1954, § 404(a) (7).
only limited percentage is determined by sound actuarial pension calculations.29

(2) The Keogh Plan has no provision for a deduction carryover for excess contributions. Thus any excess contribution would be denied a present and a future deduction. However, a corporate plan may carry over the deduction to a future year.30 The advantage of an excess contribution carryover lies in the full deduction available in later years, while one receives tax-free income in the interim. The excess contribution becomes, in effect, a tax shelter.

(3) Contributions for proprietors and partners can not be at a higher percentage of earned income than that contributed for other employees under the Keogh Plan.31 However, under a corporate plan, where integration with Social Security is more freely allowed, greater contributions can be made for higher-paid employees provided certain rather generous limits are adhered to.

(4) Under the Keogh Plan, withdrawals by proprietors or partners are entitled to a five-year income averaging provision, but a seven-year averaging provision is available for qualified corporate plans.32

(5) Under the Keogh Plan, death benefits in respect of a proprietor or partner are not entitled to the $5,000 death benefit exclusion from income tax, mentioned earlier.33

(6) A further drawback in a Keogh-type plan becomes readily apparent when one notices that every dollar placed into the Plan is subject to federal estate tax, even if the payment goes to a beneficiary other than the estate of the decedent.34 The estate tax on an accumulation of $250,000 is of course quite large. There is, likewise, no gift tax exemption with respect to the account of a proprietor or partner.35 This fact could have a significant effect on the estate of an older partner, or even a younger partner viewing his lifetime accumulations as being subject to the federal estate tax.

(7) The disability pay exclusion observed under example 2 is also not applicable to distributions under the Keogh Plan.36 Obviously, income tax liability piled on top of illness, injury, or disability may be economically disastrous.

(8) Contributions under the Keogh Plan cannot be used in computing net operating loss for income tax purposes.37

29. Treas. Reg. § 1.404(a) (6) (A) (3).
31. Treas. Reg. § 1.401(11) (d) as qualified by § 1.401(10) (a).
32. Int. Rev. Code of 1954 §§ 72(n) (2) and 72(n) (4).
33. Id. § 101(b) (3).
34. Id. § 2039(c).
35. Id. § 2517(b).
36. Id. § 105(g).
37. Id. § 172(d) (4) (D).
(9) Under the common type Keogh Plan, the account of any participant, not just that of a proprietor or partner, must be distributed to him, or at least begun as an annuity, not later than the year in which he retires or attains age seventy and one-half, whichever is later. A corporate plan is much more flexible because the elder corporate employer, who is usually in a higher bracket already, is not forced into taking a distribution at any specific time where adverse tax consequences might result.\textsuperscript{38}

(10) In Keogh, the payout on any participant's account must not be for a longer period than the joint lives, or life expectancy, of the participant and his spouse. The net effect of such a rule is to bunch a larger amount of income in a shorter period of time. The Service has not of yet placed such a requirement into corporate plans.\textsuperscript{39}

(11) Under the Keogh Plan, the Service requires a separate account for each self-employed individual to which no forfeitures can be allocated.\textsuperscript{40} Forfeitures must be applied for the benefit of the remaining eligible employees in a corporate pension or profit sharing plan.\textsuperscript{41}

(12) As a general proposition, under the Keogh Plan investments are limited to bank investment plans, endowment contracts, annuities, and insurance.\textsuperscript{42} Some corporate plans even invest in their own clinic's buildings or their own corporate stock.

(13) If a Keogh Plan covers an owner-employee having more than a 10 percent interest in capital or profits, there are more severe drawbacks. Although those clinics which have an I.R.C.-approved Super-Keogh Plan\textsuperscript{43} might think that they should not read the rest of this article because they are covered by the corporate rules, it should be made perfectly clear that should one partner accidentally own more than a 10 percent interest in capital or profits, they too would be subject to the following harsh penalties.

(14) There are severe penalties under the Keogh Plan for contributions on behalf of an owner-employee in excess of the amounts deductible under the Keogh Plan limits — especially if such contributions are willful.\textsuperscript{44}

(15) No benefits can be paid to an owner-employee before age 59 1/2, except in the event of total disability.\textsuperscript{45} Thus, a partially disabled doctor who is unable to perform 50 percent of his functions

\textsuperscript{38} Id. § 401(a) (9) (A).
\textsuperscript{39} Id. § 401(a) (9) (B).
\textsuperscript{40} Treas. Reg. § 1.401(11) (b) (3).
\textsuperscript{41} Id. § 1.401(8) (b) (4).
\textsuperscript{43} A Keogh plan where no partner has more than a ten (10) percent interest.
\textsuperscript{44} Int. Rev. Code of 1954, §§ 72(m) (5) and 401(e) (1) (B).
\textsuperscript{45} Id. § 401(d) (4) (B).
in the clinic is not entitled to a disability payment for his partial disability. Oftentimes, corporate profit-sharing plans provide for withdrawals for college education of children, building or purchasing of homes, as well as medical emergencies.

(16) The Keogh Plan must cover all full-time employees with at least three years' service. There is generally no integration with Social Security under a Keogh Plan. Further, the amounts set aside for other employees must vest immediately. A corporate plan has greater flexibility in determining eligibility for participation, allows integration with Social Security so as to permit higher-earning employees to receive a proportionately greater contribution, and lastly, provides vesting schedules so that if a man leaves or terminates early, only "X%" percent of his contribution goes with him — the rest goes either to reduce next year's pension contribution, or to the other plan members to share proportionately.

(17) Under a Keogh Plan, integration with Social Security is not permitted if more than one-third of the deductible contributions are for owner-employees.

(18) If the Keogh Plan is a profit-sharing plan, it must have a formula, although it may be flexibly designed, for contributions on behalf of non-owner employees. A corporate profit-sharing plan is much more flexible in that the Board of Directors could determine a percent of contribution at the end of the corporation's tax year. As long as contributions are made for the owner-employee in a Keogh Plan, contributions must be made for other employees, even those employees beyond normal retirement age.

(19) The limitations on (after tax) voluntary contributions by owner-employees are much stricter than in corporate plans. If the Keogh Plan covers only owner-employees, no voluntary contributions can be made. If the Keogh Plan covers both an owner-employee and other employees, voluntary contributions can be made on a comparable basis up to 10 percent of compensation, or $2,500, whichever is less.

(20) The trustee of a Keogh Plan must be a bank, unless the benefits are funded solely by insurance or U. S. Government bonds.
(21) Insurance loans and assignments, or pledges by an owner-employee, are treated as distributions subject to penalties.\textsuperscript{54} The plan itself may be disqualified if there is a prohibited transaction, such as a loan to owner-employees, their families, or members of the controlling group.\textsuperscript{55} Many corporate plans provide for loans.

(22) If a lawyer contributed property, rather than cash, to a Keogh Plan, the Plan could be disqualified because such a contribution was a prohibited transaction.\textsuperscript{56}

(23) The picture becomes even gloomier when one reads Revenue Ruling 72-98, which holds that a Keogh Profit-Sharing Plan will not qualify after March 5, 1972, if it permits owner-employees who have not attained age 59 1/2, or become disabled, to withdraw their voluntary contributions on any anniversary date of the plan. If a prototype or master Keogh Plan is used, the date is extended to March 5, 1973.\textsuperscript{57}

In this author's opinion, it is difficult to see how increasing the deductible contribution rates under a Keogh Plan will ever fully equalize the disparity between corporate and Keogh Plans. The march toward professional service corporations will therefore probably continue, for the possibility of both tax and procedural benefits will remain very desirable.

**DISADVANTAGES**

So far we have discussed merely the pros of incorporation. A corporation, and especially a professional corporation, does have many undesirable features. Naturally, the ultimate choice as to whether or not to incorporate depends upon whether the advantages outweigh these disadvantages: whether the potential benefit is worth the risk. This article will now attempt to enumerate these difficulties and then suggest alternatives to minimize the risks.

**INITIAL TRANSFER PROBLEMS**

Some specialists suggest that in order to insure a tax-free incorporation, the partnership must be dissolved — only the assets are transferred to the corporation, rather than transferring the total partnership interest per se. However, according to Revenue Ruling 70-239, it makes no difference, for the partnership will be considered to have transferred the assets regardless of the form actually employed.\textsuperscript{58} One must be wary, then, of the situation where, upon in-

\textsuperscript{54} Id. §§ 72(M) (4) and 72(M) (5).
\textsuperscript{55} Id. § 503(g) (1) (A).
\textsuperscript{56} Id. § 503(g) (1) (D).
\textsuperscript{57} Rev. Rul. 72-98, 1972 INT. REV. BULL. No. 10 at 7.
\textsuperscript{58} Rev. Rul. 239, 70-1 CUM. BULL. 74.
corporation, stock is transferred to associates of the partnership, for such a transfer may be treated as an assumption of the liabilities of the old partners.\textsuperscript{59}

Also, if one transfers property subject to a depreciation recapture under Internal Revenue Code of 1954 sections 1245 or 1250, and if no “boot” is transferred, then, as a general rule, there is no recapture.\textsuperscript{60} Boot would include cash or other property, but not the stock which the transferee receives for his property.

If one has property which would create an unrealized loss when transferred, the loss cannot be recognized under Code section 351, the tax-free exchange provision. In addition, one must be careful of Code section 267, which disallows certain losses, expenses, and interest with respect to transactions between related taxpayers. If loss property is involved, one should first sell the property to an unrelated taxpayer, take the loss and then transfer the proceeds. In this manner one would not only get the benefit of tax loss, but also a tax-free transfer of the proceeds under Code section 351.

Another important point to remember is that if liabilities are transferred, and the liabilities exceed the basis of the remainder of the property transferred in a 351 exchange, then gain will be recognized to the extent of the difference between the liabilities assumed and the basis of the remaining property transferred.\textsuperscript{61}

These “initial transfer problems” are not peculiar to professional incorporation; they extend to all incorporations regardless of size or type. Hence, if a corporate form of existence is desired, care must be taken so that such transfers do not result in needless tax liabilities.

There are still several open issues, because the Treasury has not yet published its proposed new rules to replace the old Kintner Regulations on professional associations taxed as corporations. The promised promulgations will settle many issues including, perhaps, the question of whether a professional corporation can escape tight control by incorporating under the state’s general incorporation statute, rather than under the special professional incorporation statute.\textsuperscript{62}

But one thing is clear. With the exception of the one-man professional corporation, the professional corporation has been accepted per se by the Treasury.\textsuperscript{63} But even the one-man professional

\begin{itemize}
\item \textsuperscript{59} Treas. Reg. § 1.351(1) (b) (1).
\item \textsuperscript{60} Int. Rev. Code of 1954, §§ 1245(b) (3) and 1250(d) (3).
\item \textsuperscript{61} Id. § 357(c) (1).
\item \textsuperscript{62} See State Electro-Medical Institute v. Platner, 74 Neb. 23, 103 N.W. 1079 (1905) as an example of allowable incorporation under a general state statute.
\item \textsuperscript{63} Worthy, I.R.S. Chief Counsel outlines what lies ahead for professional corporations, 32 J. of Tax. 88 (1970).
\end{itemize}
PROFESSIONAL INCORPORATION

corporation has not been looked upon with complete disfavor. In Revenue Ruling 72-4, for example, a pension plan for a sole employer-shareholder was upheld as not being discriminatory, subject to the finding that there was a true corporation — not a sham as in Roubik. However, the Tax Court has disapproved medical reimbursement plans for one-man professional corporations.

KEOGH TRANSFER PROBLEMS

Large clinics, upon seeing the pitfalls of the Keogh Plan in recent years, have been incorporating. When these clinics incorporate they can either (1) terminate the old plan, (2) transfer the assets from the Keogh Plan over to the corporate plan, or (3) "freeze" the Keogh Plan and start a separate and distinct corporate plan. Any termination of a Keogh Plan is unfortunately a premature distribution subject to tax. Obviously, this is disadvantageous.

If one merely transfers the assets from the Keogh Plan to a corporate plan, the Keogh Plan accounts must be "walled off," and they must still remain subject to the Keogh rules. There will be no premature distribution provided the assets are transferred intact. But if the assets are converted to cash and then transferred, there will be a premature taxable distribution.

To my mind, alternative two, which walls off the Keogh assets, is too costly, because a tailor-made plan must be set up. The best alternative is approved in Revenue Ruling 69-157, where the Treasury allowed the clinic to "freeze" the plan, and start a wholly separate corporate plan.

TAX AVOIDANCE PROBLEMS

Section 269 of the Code provides, in effect, that if any person or persons acquire control of a corporation, and the principal purpose for such acquisition was the evasion or avoidance of federal income tax, such as by securing the benefit of a deduction, credit, or other allowance, then the Commissioner may disallow such deduction, credit, or other allowance. No case, however, has held that incorporation to obtain deductions for contributions to qualified fringe benefit plans is within the ambit of Code section 269. In fact, in Kurzner v. United States, the court noted:

70. 413 F.2d 97 (5th Cir. 1969).
It may also be observed that the desire for pension and profit-sharing plans is not purely a tax motive; insofar as the desire is for economically feasible retirement and work-incentive plans, it is clearly a non-tax motive. However, it is appropriate to note that we intimate no view whatever as to the effect of section 269 of the Internal Revenue Code of 1954 in regard to professional service corporations.

"Business purpose" nevertheless can be found in a desire for centralized management and limited liability.

In this regard, Code section 482 enables the Commissioner to distribute, apportion or allocate gross income, deductions, credits or allowances between or among commonly controlled organizations if necessary to prevent evasion of taxes or to clearly reflect the income of such organizations. The effect of this section in the professional corporation context could be to reduce corporate income, by imputing it to the former partnership and thereby lowering the salaries of shareholder-employees and contributions to qualified plans. Or, in the case of incorporation, receivables may have been diverted from the partner to the corporation, and the government may feel that these receipts should be taxed to the partners, and not to the corporation. The analysis and illustration of Code section 482 and related problems can best be visualized in the instance of a transfer of accounts receivable.

The Treasury can level three attacks upon the propriety of transferring accounts receivable to a corporation:

1. The transfer is in reality an assignment of income from the one who earned the income to a corporate entity who did not. The resultant distortion of income is to be avoided at all costs.

2. The corporation has not clearly reflected income under Treasury Regulation 1.446-1(a)(1) when it includes taxable receipts of the partners.

3. Under Code section 482, there is a distortion of income between two taxable entities caused by the transfer.

Note that until a few years ago, some cases have held that a transfer of accounts receivable as a portion of the entire business under Code section 351 (tax-free incorporation) would result in no tax on the transfer of such accounts. The receivables, however, would have a zero basis in the hands of the corporation.

71. Id. at 101.
72. 410 F.2d 888, 898 (6th Cir. 1969).
74. Birren v. Comm’, 116 F.2d 718 (7th Cir. 1940); Ezo Products Co., 37 T.C. 385 (1961); Paul H. Travis, 47 T.C. 502 (1967).
But in 1966, the Tax Court decided Peter Raich, wherein it was determined that the receivables were not taxable except where the adjusted basis of the property transferred is exceeded by the liabilities assumed. But, in Nash v. United States, a recent Supreme Court case, the bad debt reserves on the accounts receivable were not considered income to the transferors when transferred. Now many conservative tax practitioners feel that a transfer of accounts receivable will be initially tax-free.

If the problem of a potential reallocation of income under Code section 482 arises, the Treasury will undoubtedly rely on Rooney v. United States and Brown v. Commissioner to uphold the reallocation. The Brown case held that when an attorney assigned receivables (legal fees) to a corporation which had no assets other than the transferred receivables, tax to the attorney resulted. There is contra authority in Thomas W. Briggs and Arthur L. Kniffen. As of this date the issue is unresolved.

Until this controversy under Code section 482 is resolved, it is best to obtain a Service ruling, commonly called a closing agreement, before a decision to incorporate is acted upon. Chief Counsel Worthy has indicated that closing agreements will be given where both accounts receivable and accounts payable have been transferred. But even if the accounts receivable will not be reallocated, one must still be careful not to incorporate where the liabilities are in excess of the basis of the property transferred.

Finally, the warning in Robert L. McCoy points to the fact that the partnership should be "cleaned up" before incorporation, by paying off all liabilities. Those accounts payable which are transferred to and paid by the corporation will not be deductible by the new enterprise. The best solution is to pay off the accounts payable before incorporating, or to keep enough property in the hands of the former partners to cover these payables.

**INCOME BUNCHING PROBLEMS**

The toughest problem, which as yet remains unresolved, is the

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75. 46 T.C. 604 (1966).
78. 305 F.2d 681 (9th Cir. 1962).
79. 115 F.2d 337 (2d Cir. 1940).
80. Id. at 339.
81. 25 P.H TAX CT. MEM. ¶ 56,086 (1956).
82. 39 T.C. 553 (1962).
84. INT. REV. CODE of 1954, § 357 (c) (1).
85. 40 P.H TAX CT. MEM. ¶ 71,034 (1971).
86. 46 T.C. 604; Velma W. Alderman, 55 T.C. 662 (1971).
incorporation of a fiscal year partnership, since a bunching of income problem will generally result.

Example: A partnership with a January 31, 1972, fiscal year incorporates effective February 1, 1972. The distributive share of the partnership's 12 months' income (February 1, 1971 - January 31, 1972) will be included in the partner's 1972 calendar tax year. The partners, however, will also be receiving a salary for eleven months in 1972 from the corporation, and if the salary is equal, or nearly equal, to that which would have been his distributive share of partnership profits, the result is inclusion of 23 months' income in one

calendar year.

Unfortunately, there is no ideal solution which will cure the problem; there are merely alternative means, each of which has its own drawbacks.87

The alternative solutions are as follows:

(1) Payment of reduced salaries for the first year of corporate existence.

(2) Continuation of the partnership after incorporation plus payment of low salaries.

(3) Subchapter S election.

There are many ways to pay reduced salaries. Some methods are:

(1) Quarterly payment of salaries on the first day of the next succeeding quarter.

(2) Payment of salaries once a year.

(3) Spreading payment of salaries accrued in the first year over a period of several succeeding years.

In regard to the second alternative, if the partnership were to retain the accounts receivable of the partnership, and the corporation paid low salaries in the year of incorporation, the problem would be mitigated, since only the receivables actually collected, in addition to the smaller salary, would be income to the former partners.

On the other hand, if one set up a Subchapter S corporation by electing a fiscal year which corresponds with that of the predecessor partnership's fiscal year, the bunching problem may be mitigated by paying low salaries and distributing all, or nearly all, of the corporation's income at the close of its taxable year. The Subchapter S election is perhaps the poorest alternative of the three because of the limitations on qualified pension and profit-sharing plans introduced by the Tax Reform Act of 1969.88


All solutions to the bunching problem have one thing in common — low salaries. The individual would have little cash flow in the year of incorporation, and this would entail borrowing or living on one's savings. If the older professional has sufficient liquid savings he is capable of meeting this handicap. Since the salary will be eventually paid, he loses nothing except the return on his liquid investments which he must now use.

The younger professional is in a tougher situation. For example, the younger physician, already in debt, and just beginning to taste the good life after suffering through residency, internship, and medical school, either cannot borrow or does not desire to. He must, however, take part in the incorporation. While he can take greater advantage of income averaging generally, he must still borrow, knowing that eventually the same total salary will be paid to him. The low salary received in the first year of incorporation can be made more attractive by bonuses and/or a higher salary in the following year.

Other inducements might also be employed. Perhaps the other physicians can become accommodation endorsers at a local bank. Perchance an agreement for time payment of the tax liability can be reached with the collection division of the Service. Perhaps a loan could be arranged from a pension or profit-sharing plan. Each situation facing a young physician requires careful analysis. In the long run, the receivables earned will produce the same amount of income, and the loan can be paid off. The yearly tax disadvantage caused by bunching of income in many cases can be overcome by the yearly tax advantage gained through the tax shelters the corporation provides, such as pensions, profit-sharing plans, sick pay, and group-term life insurance. But perhaps a feasibility study should simply be performed to determine whether the corporation is really advantageous or not for each man desiring to take part.

Compensation Problems

The major controversy in the professional corporation area deals with unreasonable compensation and the requirement for an automatic dividend. Until recently, most of us have assumed, under the authority of the Klamath case, that compensation which does not exceed the amount of professional income of the practitioner before incorporation is probably safe from attack.

Now, however, it seems that there are two key issues that the Treasury might pursue on professional corporations:

(1) Is there a dividend problem even where compensation is con-
cededly reasonable?

(2) If dividends must be paid on invested capital, does capital in-
clude goodwill?

The net effect of the Service's attack would be to deny a salary
deduction, force the declaration of a non-deductible dividend, and
also force income into the hands of the shareholder-employee. In
short, this would double tax the dividend, once at the corporate level
and once at the individual level.

In the case of Charles McCandless Tile Service v. United States,90
the Court of Claims found that, despite concededly reasonable com-
pensation, invested capital was entitled to a dividend of 15% of net
profits before salaries and federal income tax. The court com-
mented:

Even a payment deemed reasonable, however, is not deduc-
tible to the extent that it is in reality a distribution of corpo-
rate earnings and not compensation for services rendered.91

The Tax Court in the recent memorandum decision of Barton-
Gillet Co.92 has followed suit and looked for a fair return on capital
first, and then determined what a reasonable salary should be.

Both McCandless and Barton-Gillet seem to put the cart before
the horse — that is, the return on capital is made before salary is
paid. Under general corporate law, return on equity is always
figured as a residual amount, after the deduction of salaries. If the
salary is reasonable and there is little or nothing left over for equity
interest, then the shareholder is left with little or nothing. One can
only wonder why such a double standard exists.

In another recent case, Nor-Cal Adjusters,93 the Tax Court seemed
to ease off from the automatic dividend rule. The rule propounded
there used the lack of a solid dividend history as only one of the fac-
tors to determine whether the salary was reasonable. But in another
case,94 a California court found goodwill in a physician's practice.
Suppose that a return on capital must include a return on an intangi-
ble goodwill value of the practice. A five percent dividend on book
value including goodwill would be considerably larger than a five
percent dividend on book value alone, and could quickly reverse
the current trend toward incorporation.

Until the issue is finally resolved, careful planning should include
the following:

90. 422 F.2d 1336 (Ct. Cl. 1970).
91. Id. at 1339.
(1) Low capitalization to avoid a large dividend.

(2) Maintenance of a buy-sell agreement in the partnership and the corporation to limit goodwill.

(3) Selection of Subchapter S status to avoid dividend treatment if the corporation has ten or fewer shareholders. Or, in the alternative, the professional may even continue the partnership and lease the names to the corporation at a set fee. If there are more than ten shareholders, this approach seems best.

One additional lesson learned from the *Nor-Cal Adjusters* case is that a bonus, to be deducted as salary, must not be paid from available profits in the exact proportion of shareholdings, unless related to performance. A bonus can be deemed a disguised dividend which would produce double taxation, once at the corporate level as a dividend, and once at the shareholder level as ordinary income.

**Medical Reimbursement Plan Problems**

We have seen that medical reimbursement plans under Code sections 105 and 106 are deductible by the corporation and that the recipient has no income. But, if the reimbursement is going to a shareholder who is not an employee or to a sole shareholder-employer, then the deduction is denied. Instead, the reimbursement is treated as a non-deductible dividend, again subject to double taxation.

This is not to say that the plan may not discriminate in favor of employees who are also shareholders. However, such discrimination, if not specifically provided for by the terms of the plan, may be taken into account in determining whether the plan was "for employees."

Payments under medical plans are not subject to the reasonableness test applied to compensation under Code section 162 — because they are considered business expenses deductible under Treas. Reg. § 1.162-10(a).

**Accumulation Problems**

Since the Code gives a professional corporation a $100,000 leeway before finding an unreasonable accumulation, and since the professionals usually will want to receive as high a salary as possible,
capital accumulations in the corporation are rare. It is rather surprising to find, however, that an item which might not be deductible for corporate income tax purposes may be used to reduce an unreasonable accumulation. For example, key man insurance and excess group term insurance over $50,000 may be so used to reduce an unreasonable accumulation. Some tax men suggest excess contributions to the qualified pension or profit-sharing plan, even though these excess contributions are non-deductible, due to the fact that unreasonable accumulation would thereby be reduced or eliminated.

However, in Novelart Manufacturing Co. v. Commissioner, the court:

(1) denied an income tax deduction on premiums for key man insurance; and

(2) denied the taxpayer a specific deduction from taxable income to arrive at accumulated taxable income under Code section 535(b), because the Code does not specifically provide for such a deduction; and

(3) held that the payment of premiums on a sole or majority shareholder’s life was not a reasonable need of the business, as required in Code section 535(c), and thus the premiums could not be used to reduce the unreasonable accumulations.

The possibility still exists that pre-funding a buy-sell agreement may be a legitimate business need under Code section 535(c), because the factual setting may so require. The basic test is whether a corporate business purpose is satisfied. For example, redemption or key man insurance is allowable for purposes of redeeming minority shares. The facts of each case will determine whether or not a business need is satisfied.

There is an additional potential seventy percent penalty tax imposed on the “undistributed personal holding company income” of a professional corporation if: (1) more than 50 percent in value of outstanding stock is owned (directly or indirectly) by, or for, not more than five individuals, and (2) at least 60 percent of the corporation’s “adjusted ordinary gross income” for the taxable year consists of “personal holding company income.” Such income is

100. INT. REV. CODE of 1954 § 535(c) (1).
102. Id. at 1012.
103. Id.
104. Id.
107. INT. REV. CODE of 1954 §§ 541 and 542.
generally dividends, interest, royalties, rents and "income derived from personal service contracts." To constitute personal holding company income, income from personal service contracts must be: (1) derived from a "contract" under which the corporation is to furnish personal services, (2) a person other than the corporation must have the right to designate (by name or description) the individual who will perform the services, and (3) the individual who performs, or who may be designated, owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation at "some time" during the taxable year.

The Committee reports recognize that:

the (client's right of designation) will prevent this rule from applying in general to operating corporations engaged primarily in rendering personal services... Thus corporations which let out the services of architects, engineers, and advertisers would not as a general rule be required to report such income as personal holding company income.

[Emphasis supplied]
The Service has taken the position that "contract" includes oral as well as written agreements, and therein might be included an agreement for professional services with one who holds a 25 percent interest in the professional association. The simplest solution lies in barring the client's right to designate who will perform the services desired. In the S. O. Claggett, Inc. case, the Tax Court held that the "mere expectation" that a certain person will perform services is insufficient to amount to a designation. That case involved a one-man corporation. Unfortunately, a case by case approach is necessary to determine whether there is either a designation or there exists a right to designate.

Under Code section 341(a), the gain from the sale or exchange of the stock of a collapsible corporation, or a distribution in partial or complete liquidation of a collapsible corporation, will be taxed at ordinary income rates.

CONCLUSION

The most difficult problem in professional corporations is caused not by the law but by people. There is so much coffee-room hearsay that many professionals hear only conflicting points of view. Con-
fusion abounds. The only way to settle this confusion is to do a dollars and cents analysis for each professional to determine the yearly mathematical advantage of incorporation. A conference should then be scheduled with each professional to resolve his doubts and to show his gain or loss on incorporation. In that way it will be easier to dispel any doubt.

If a feasibility study is made by a professional who knows the problems of other professionals, very few practices will regret their choice to incorporate. If problems do develop, they will develop before incorporation, at a time when they can be resolved to the satisfaction of all parties through pre-incorporation agreements.

After the feasibility study is complete, one can accurately weigh the benefits against the potential cost, and the risk inherent in a government determination that there was no professional service corporation.

It is this author's belief that the benefits in most cases outweigh the cost and the risk. In short, one has everything to gain and nothing to lose.

Prospects

The aura of tax reform is in the air again. Surprisingly this air of reform will aid the professional corporation. As the tax shelter loopholes are closed, the efforts of most professionals to achieve tax parity will turn more toward the professional corporation. The professional will see his corporate executive neighbor with his fringes protected by tax shelters and will desire the same advantages.

One would think that President Nixon's proposal to (1) raise the Keogh deduction to 15% with a maximum of $7,500 and (2) to allow individual retirement plans with yearly contributions of up to $1,500 on top of the Keogh plan might cut down on the race to incorporate. Not so, because most knowledgeable professionals realize that every dime in the Keogh plan is subject to estate tax, while employer contributions to qualified corporate plans are not subject to estate tax under Code section 2039(c).

Not only will the estate tax savings attract doctors and lawyers to the professional corporation, but also the increase in net spendible income, realized when the corporation pays for such things as health insurance, educational meetings, and life insurance. This net increase in spendible income is welcomed by both the older and the younger professional.

When the advantages of the professional corporation are further and fully explained in terms of a well-managed investment, having both tax shelter advantages and growth potential, the recruitment of younger professionals will be easier and corporate practice will grow. The march toward professional incorporation continues.