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Tax and Corporate Aspects of Professional Incorporation in North Carolina

A common aspiration of many licensed professionals to enjoy the legal right to practice in the corporate form in North Carolina was fulfilled with the passage of the North Carolina Professional Corporation Act. Effective on January 1, 1970, this legislation is timely indeed. The predominant benefits available to professionals who practice within a corporate structure recently became more assured when the Internal Revenue Service unexpectedly, albeit realistically, conceded that doctors, lawyers, and others organized under state professional association or corporation laws would, generally, be treated as corporations for federal tax purposes. Both the tax and corporate advantages and limitations of professional corporations will be discussed in this comment.

I. Historical Background

Under section 7701(a)(2) of the Internal Revenue Code of 1954, which has been the same under all revenue acts, a "partnership" is inclusively defined as: "A syndicate, group, pool, joint venture or other unincorporated organization . . . ." It is necessary to look at section 7701(a)(3) to determine what an "incorporated organization" is. This section provides that "[t]he term 'corporation' includes associations, joint stock companies, and insurance companies." The key word in this definition—"association"—is not defined elsewhere in the Code. How-

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6 Code § 7701(a)(2) (emphasis added).
ever, in *Morrissey v. Commissioner*\(^8\) the Supreme Court established some judicial guidelines to determine the primary characteristics an organization, not formally incorporated under state law, must have in order to be an "association" for federal tax purposes.

The Court held that a business trust having certain corporate characteristics constituted an association taxable as a corporation within the meaning of the Code. The important characteristics cited by the Court were the following: beneficial interests being transferable without affecting the continuity of the business; owners' liability being limited; an owner's death neither terminating nor interrupting the business; management of the business being centralized through representatives of the owners; and title to the property being held within the entity.\(^9\)

The IRS applied the criteria of *Morrissey* in *Pelton v. Commissioner*\(^10\) to win its first and last victory in the courts concerning the tax status of a professional corporation. The court held that a medical group, which ironically did not wish to be taxed as a corporation, more closely resembled an association than a partnership for federal tax purposes. But with the advent in popularity of corporate pension and profit-sharing plans in addition to the increasing number of close corporations, the IRS was ultimately destined to regret its victory in *Pelton*.

In *United States v. Kintner*,\(^11\) a group of doctors organized their partnership into an "association," primarily to obtain the tax benefits of a qualified corporate pension plan. The court held that the group was an association taxable as a corporation even though a corporation could not practice medicine at that time under the law of the appropriate state. The court also emphasized that classification of an entity for federal income tax purposes is a question of federal, rather than state, law.\(^12\)

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\(^8\) 296 U.S. 344 (1935).

\(^9\) Id. at 359.

\(^10\) 82 F.2d 473 (7th Cir. 1936).

\(^11\) 216 F.2d 418 (9th Cir. 1954).

Applying federal law, the court found that the particular medical group possessed more corporate characteristics under the tests of *Morrissey* than attributes unique to a partnership.\(^\text{13}\)

The IRS initially refused to follow *Kintner*,\(^\text{14}\) but in 1960 it promulgated regulations outlining the "resemblance test" from *Morrissey* for determining a group's status as an "association." The regulations closely adhered to the opinion in *Kintner*.\(^\text{15}\) However, contrary to the court's refusal in *Kintner* to accord state law any importance in determining whether an organization is a corporation or a partnership for tax purposes, the IRS emphasized that the presence of the characteristic outlined in *Morrissey* would be governed by local law.\(^\text{16}\) Since local law in most states did not recognize professional groups as capable of having any corporate characteristics, the motive behind the Treasury's emphasis on local law is obvious. Not wishing to press the issue judicially at that time, the professional groups turned to their state legislators and asked them to provide for professional corporations that would inherently possess the acceptable characteristics. The professionals also received a partial response to their pressures from Congress in the form of the Self-Employed Individual's Retirement Act.\(^\text{17}\)Realizing that the emphasis it had placed on local law was seriously backfiring, the IRS amended its regulations in 1965 to provide that, regardless of state labels, a "professional service organization" must meet the "resemblance test" of *Morrissey* to be treated as a corporation.\(^\text{18}\)

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\(^{13}\) The IRS attempted to equate this case with Mobile Bar Pilots' Ass'n v. Commissioner, 97 F.2d 695 (5th Cir. 1938), in which an association of pilots attempted to be treated as a corporation for tax purposes. The court in *Kintner* distinguished the two cases. It reasoned that the pilots' association would not have been liable for any acts of its members, that the association owned no property and had no income as an entity, and that the association was merely an agent of the pilots, instead of their employer, because the owners of the vessels for whom the pilots performed their services employed and controlled them. 216 F.2d at 423.

\(^{14}\) Rev. Rul. 56-23, 1956-1 CUM. BULL. 598. The Treasury later conceded that an association of doctors could achieve corporate status if it possessed the "necessary attributes." Rev. Rul. 57-546, 1957-2 CUM. BULL. 886.

\(^{15}\) Treas. Reg. § 301.7701-1(c) (1965), T.D. 6503, 1960-2 CUM. BULL. 412.

\(^{16}\) Id.

\(^{17}\) Self-Employed Individual's Retirement Act, 76 Stat. 809 (1962). See Code §§ 401(a), (c), (d) & (e); Treas. Reg. §§ 1.401-10 to -13 (1963). This provision limits the amount a self-employed individual may invest in a qualified tax-exempt pension plan to the lesser of ten per cent of his salary or 2500 dollars.

\(^{18}\) Treas. Reg. § 301.7701-1(c) (1965). Treas. Reg. § 301.7701-2(a)(3) (1965) provides that the "resemblance test" is determinative of the corporate tax treatment and, furthermore, that the unincorporated organization seeking to be taxed as an association must have more corporate characteristics than noncorporate
The amended regulations persuaded the professional groups that their only recourse was additional judicial review. The courts were unanimous in recognizing the validity of professional corporations although different reasoning was applied to reach identical results.¹⁹ Not only did the IRS finally concede the general validity of professional corporations,²⁰ but it also indirectly apologized to the professionals and the courts for its historical position by successfully supporting a Senate amendment to the Tax Reform Act of 1969 that allows professionals the spoils of their victory for the time being.²¹

II. TAX ADVANTAGES AND LIMITATIONS OF PROFESSIONAL INCORPORATION²²

A. Employee Fringe Benefits

The primary and most tangible tax benefit derived from professional incorporation is that the professional is treated as an employee of the corporation for tax purposes. By gaining the status of an employee, the professional can earn a straight salary from his corporation for his services and receive certain fringe benefits not taxable to him as income.

¹⁹ Compare O'Neill v. United States, 410 F.2d 888, 891 (6th Cir. 1969) and United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969) (both holding that the "resemblance test" of Morrissey might be applicable in determining the corporate status of a business trust, but that state law is controlling as to whether an entity is a "corporation" for tax purposes) with Kurzner v. United States, 413 F.2d 97, 112 (5th Cir. 1969) (holding that the "resemblance test" of Morrissey is a valid criterion for determining whether an entity is a corporation for tax purposes and that state law is not determinative).

²⁰ See note 3 supra. The IRS did not approve or disapprove the different theories of the courts upholding professional corporations. Nevertheless, all of the cases before the courts thus far have involved organizations with two or more professional employee-shareholders; different problems face the single professional who wishes to incorporate. See pp. 586–89 infra.

²¹ 115 Cong. Rec. S162481 (daily ed. Dec. 9, 1969) (letter from Asst. Sec. of Treasury Cohen to Senator Hruska supporting Senate Amend. 296 deleting § 901 of H.R. 13270, which imposed the "Keough" limitation on shareholder-employees of professional service organizations) (the amendment passed 65 to 25).

²² The term "professional corporation" is intended to apply to any organization of professionals, including a professional association that is not formally incorporated under state law, if it is treated as a corporation for federal-tax purposes.
In return, the employer-corporation may deduct the cost of such fringe benefits from its income as an ordinary and necessary expense under Code section 162(a)(1).

1. Pension and Profit-Sharing Plans

An employer-corporation can contribute, tax-exempt to an employee, up to fifteen per cent of his salary to a qualified pension or profit-sharing plan and even up to twenty-five per cent to a qualified combination of a pension-and-profit-sharing plan. The corporation's contribution to the qualified fund for the benefit of the employee is immediately deductible to the employer under Code section 404(a). The employee is not taxed until a later distribution from the trust fund to him either in the form of a lump-sum payment or a retirement annuity. Moreover, amounts remaining unpaid from the pension or profit-sharing trust fund at the death of the employee will be exempt from estate taxes if he has designated a beneficiary other than his estate. In summary, since earnings building up within the trust fund are tax-exempt, the use of a qualified deferred-compensation plan to accumulate a retirement portfolio amounts to an investment in a tax shelter that cannot be found elsewhere in the Code.

The most important limitation on a pension or profit-sharing plan is that it must be qualified under the Code. A principal cause of a plan

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23 Code § 404(a)(3). A self-employed individual is only allowed to contribute the lesser of 2500 dollars or ten per cent of his salary to a qualified plan. Id. § 404(c). See generally id. §§ 401-404.

24 Code § 404(a)(7). The advantages to the higher-salaried employee of not being taxed on an employer's contribution to the qualified trust fund is somewhat lessened by the reduction in the Tax Reform Act of 1969 of the maximum income-tax rate for individuals to fifty per cent. See Pub. L. No. 91-172 § 804(a) Dec. 30, 1959) adding Code § 1348 (effective for taxable years after 1971).


26 Before the Tax Reform Act of 1969, Code § 402(a)(2) provided that the taxable portion of a lump-sum distribution from a qualified deferred-compensation plan would receive capital gains treatment if distribution was completed in one taxable year of the employee. However, Pub. L. No. 91-172 § 515(a) (Dec. 30, 1969) added Code §§ 402(a)(5) & 403(a)(2)(c). These sections provide that the portion of the lump sum contributed by the employer is taxable to the employee as ordinary income, subject to a special maximum under new Code § 72(n)(4).

27 Code § 2039(c). See Code § 2517 for an available gift-tax exemption for the employee to the extent of his own contributions to the plan if he irrevocably designates a beneficiary other than himself.

28 For an excellent discussion of the suitability of the pension or profit-sharing plan, or both, for certain professionals in various situations, see H. Jones, Professional Corporations (PLI, Tax Law and Practice Course Handbook Number 14, 1968).

29 Code § 401.
failing to qualify is that it is discriminatory in coverage, contribution, or benefits in favor of the higher-salaried employees. An additional limitation is imposed by the Tax Reform Act of 1969 on the amount an employer-corporation can contribute to a qualified plan for the benefit of an employee. If the employer has elected to be taxed as a Subchapter S corporation, then the "Keough" limitation will be imposed on the amount it can contribute for the benefit of a shareholder-employee owning more than five per cent of the outstanding stock without his having the contribution taxed as income. The future of the extensive and unique benefits available to an employee under a qualified pension or profit-sharing plan is uncertain; the Treasury Department has undertaken an extensive review of all deferred-compensation legislation. The objective of this review is to eliminate the distinction in the present law between qualified deferred-compensation plans for self-employed persons and corporate employees. If extensive changes tending to equalize the status of the two are forthcoming in the near future, one of the principal incentives for professionals to incorporate will be neutralized.

2. Wage-Continuation, Accident, and Health Plans

Another fringe benefit available to a professional as an employee of the corporation is under Code section 105(d), which provides that an employer may continue to make salary payments to a disabled employee or purchase disability insurance that will accomplish the same results and take a deduction for the payments or premiums. Furthermore, neither the premiums nor the payments are taxable to the employee if they are

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31 Code §§ 1371-78.
32 See note 17 supra.
33 Pub. L. No. 91-172 § 531(a) (Dec. 30, 1969), which added Code § 1379. If the Subchapter S corporation contributes more than the amount allowed under the "Keough" limitation, it will still get a deduction, but the excess will be taxed as income to the employee. However, any amount taxed currently to a shareholder-employee is to be recovered later by him tax-exempt under the annuity or lump-sum-distribution rules of Code § 72(n).
35 Id.
below one hundred dollars per week and comply with certain additional limitations.\textsuperscript{37}

The employer-corporation may also reimburse the employee for expenses for medical care for himself, his spouse, and his dependents,\textsuperscript{38} or the employer may pay the premiums on an accident and health insurance plan that provides compensation for expenses incurred by an employee for personal injuries to or sickness of himself, his spouse, and his dependents.\textsuperscript{39} In neither alternative are the payments normally taxable as income to the employee-beneficiary,\textsuperscript{40} and in both alternatives, the payments are normally deductible by the employer as an ordinary and necessary business expense.\textsuperscript{41}

In addition to utilization of employee-insurance plans to achieve tax benefits for itself and its employees, the employer-corporation may elect to be covered by workmen's compensation under section 97-1 of the North Carolina General Statutes.\textsuperscript{42} Under Code section 104(a)(1), payments received by an employee under workmen's compensation are generally tax-exempt.

3. Group Life Insurance and Death-Benefit Plans

The employer-corporation can purchase up to fifty thousand dollars of group life insurance for each employee and deduct the premiums as an ordinary and necessary business expense\textsuperscript{43} without the employee's having to pay income taxes on the payments.\textsuperscript{44} The group insurance may not be discriminatorily limited to the professional shareholder-employees


\textsuperscript{39} Code §106. See Treas. Reg. §1.105-2 (1956). A self-employed individual's deduction for medical expenses is allowed only to the extent that they exceed three per cent of his adjusted gross income and are not covered by insurance. One half of the individual's premiums not in excess of 150 dollars for insurance coverage for himself, his spouse, and his dependents is also allowed as a deduction. Code §213.

\textsuperscript{40} Code §106. See Treas. Reg. §1.105-2 (1956).

\textsuperscript{41} Code §162. See Treas. Reg. §1.162-10 (1958). Currently it is uncertain whether medical-reimbursement and sick-pay plans can be discriminatorily limited to the employees who are shareholders. But see Larkin v. Commissioner, 48 T.C. 629 (1967) (nondiscrimination test to a medical-reimbursement plan added). However, as suggested by one writer, even though the law in this area is not fully developed, it might be reasonable to relate benefits to service or salary and thus effectively discriminate in favor of the shareholder-employee. Malone, Professional Corporations—A Current Appraisal, 23 Ark. L. Rev. 215, 219 (1969).


\textsuperscript{44} Code §79(a).
although the amount of coverage for which each employee is eligible may be based on such factors as salary, years of service, position, or a combination of factors.46

The employer-corporation also may give five thousand dollars on the death of an employee to his estate or beneficiary, and the payment is not taxable as income to the employee46 while it is deductible by the employer.47 The primary limitation to this tax-exempt benefit is that the employee must not have had a nonforfeitable right to the payment immediately before his death since such a right is considered the equivalent of compensation due the employee for services.48

B. Tax Problems of Shareholder-Employees

Since most professional-employees in a professional corporation will also be shareholders,49 deductions and other tax benefits to the corporation indirectly inure to the benefit of the shareholder-employee. Because of the inherent control and a temptation to use it to achieve illegal tax benefits, there are statutory and judicial limitations on the relationship between the shareholder-employee and his employer-corporation to insure that the relationship is bona fide and not used principally to avoid taxes for which the corporation or shareholder would otherwise be liable.

1. Retained Earnings

The earnings of most professional corporations will usually be taxed at a lower rate than if they are distributed in the form of salaries to the professional employees;60 therefore, it will often be to the benefit of the higher-paid employees for the corporation to retain some earnings for future needs. Retained earnings could be invested in outside property

46 Treas. Reg. §§1.79-1(b) (1) (b), & (d) (1966).
47 Code § 101 (b) (2).
49 Code § 101 (b) (2) (B). See Treas. Reg. § 1.101-2(a) (2) (1957). Apparently discrimination among employees in respect to this tax-free benefit is not only not forbidden, but approaches the point of being required to prevent the implication of a nonforfeitable right.
50 The North Carolina Professional Incorporation Act, N.C. Gen. Stat. §§55B-1 to -15 (1969), as do similar acts in other states, limits stock ownership in professional corporations to professionals licensed in the profession that the corporation practices. However, it is not necessary for a shareholder to be an employee of the corporation, nor is it necessary for a professional employee to own stock in it. Id. at § 55B-4(2).
51 The normal federal tax is twenty-two per cent of the first 25,000 dollars of taxable corporate income and forty-eight per cent of the excess over that amount. Code § 11.
or stock, and the professional corporation would receive an eighty-five per cent "dividends received deduction" for dividends from stock in another corporation.\footnote{Id. § 243.} To control such a situation, there are certain statutory limitations not only on the amount of earnings that may be retained, but also on the feasibility of retaining any earnings at all.

Under Code section 531, there is a penalty tax on any earnings and profits retained in excess of 100,000 dollars that are "beyond the reasonable needs of the business."\footnote{Id. §§ 531- to -37.} Exactly what constitutes the "reasonable needs" of professional corporations is uncertain.\footnote{For a good discussion of "reasonable needs of the business," see BITTKER \& EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 6.03-.07 (2d ed. 1966; Supp. 1969) [hereinafter cited as BITTKER].} It is unlikely that most professional corporations would need large amounts of retained earnings for future capital assets or retirement of debts. One primary reason for most professional corporations to retain and reinvest earnings and profits will be to build up a ready fund to redeem the stock of a retiring shareholder-employee under a redemption agreement.\footnote{Under most circumstances the corporate redemption agreement is far superior to the shareholder buy-sell agreement. The danger of a shareholder buy-sell agreement is that when one stockholder wishes to retire, the remaining shareholders may not have the liquidity to purchase his stock. If the remaining shareholders attempt to assign the buy-sell agreement to the corporation or attempt to use corporate funds to purchase the shares, the "loan" by the corporation could be taxed to the buying shareholders as a constructive dividend or discharge of their indebtedness. E.g., Wall v. United States, 164 F.2d 462 (4th Cir. 1947). See 2 F. O'NEILL, CLOSE CORPORATIONS § 7.13 (1958).} In \textit{Mountain State Steel Foundries, Inc. v. Commissioner},\footnote{See, e.g., Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir.), \textit{cert. denied}, 356 U.S. 958 (1958) (corporate accumulations for stock redemptions of controlling shareholder not a valid reasonable need of the business); BITTKER § 6.07. Professor Bittker points out that the importance of a redemption to a corporation's business activities is often tenuous or debatable while the interest of the remaining shareholders in achieving an increase in their proportional control is obvious. He suggests caution as a result of the unsettled state of the law, especially if the contemplated redemption is not likely to occur until a distant future date.} the retention of earnings and profits by a corporation for stock redemption purposes was held to be a reasonable need of the business. There have been decisions to the contrary,\footnote{\footnote{284 F.2d 737 (4th Cir. 1960).} but notwithstanding this conflict, under section 55B-7(b) of the North Carolina General Statutes, the professional corporation is required to redeem a deceased stockholder's shares within one year of his death if the remaining shareholders choose not to purchase them.}
Thus the accumulation of earnings by a professional corporation for future redemptions may not only be a "reasonable need" of the business but also one necessary to maintain existence since the Secretary of State of North Carolina must revoke a professional corporation's charter unless the deceased stockholder's shares are either redeemed or purchased by the remaining shareholders.\textsuperscript{67} It may be significant that the Tax Reform Act of 1969 contains an amendment to Code section 537 redefining "reasonable needs of the business" to include amounts needed, or reasonably anticipated to be needed, to redeem stock under Code section 303 for the payment of death taxes of a deceased shareholder.\textsuperscript{68}

A more costly but objective limitation on the feasibility of a professional corporation's retaining any earnings or profits undistributed in salaries or dividends is Code section 541, which pertains to personal holding companies. If a corporation meets criteria so that it can be classified as a personal holding company, then all of its undistributed personal-holding-company income will be subject to a confiscatory tax of seventy per cent.\textsuperscript{69}

To be classified as a personal holding company, more than fifty per cent of a professional corporation's stock must be owned actually or constructively by five or fewer individuals,\textsuperscript{70} and, in addition, sixty per cent or more of the corporation's adjusted ordinary gross income must be "personal-holding-company" income.\textsuperscript{61} Since substantially all of a professional corporation's income will be derived from the rendering of personal services by the employees to clients or patients, Code section 543(a)(7), which characterizes income derived from personal-service contracts, is highly important. Income for personal services under this provision will be deemed personal-holding-company income only if the recipient of the

\textsuperscript{67} N.C. GEN. STAT. § 55B-7(b) (1968).
\textsuperscript{68} Pub. L. No. 91-172 § 906 (Dec. 30, 1969) amending CODE § 537. The amendment provides that the reasonable needs of the business (CODE § 537) include amounts needed (or reasonably anticipated to be needed) in the year of death and subsequent years to redeem stock to pay death taxes (CODE § 303). S. Rep. No. 552, 97th Congress, 1st Sess. 11 (1969). A reasonable interpretation of this provision is that the accumulations under CODE § 537 for a redemption under CODE § 303 must be in the year of death of the shareholder, or later, to be characterized as a reasonable need of the business. E.g., P-H, 1970 FED. TAXES, REP. BULL. 1, § 230. Nevertheless, it would seem that the logical intent of Congress and a possible interpretation would be that accumulations before the death of a shareholder whose stock is to be redeemed under CODE § 303 is a reasonable need of the business.
\textsuperscript{60} CODE § 542(a)(2).
\textsuperscript{61} Id. 542(a)(1).
services is able, under a contract expressed or implied, to designate who must perform them and if the person who may be designated owns, either actually or constructively, twenty-five per cent or more of the corporation's outstanding stock. Of course, the ability of the recipient of personal services to designate who must perform them will often be determined by the practices and procedures of a particular professional corporation.\(^6\)

The statutory prohibition on personal-holding-company income was primarily aimed at persons in the entertainment world who incorporate,\(^3\) and the statute has questionable applicability to a bona fide professional corporation rendering personal services to the public and owning substantial capital assets.\(^6\) It is obvious from the legislative history that the statute was not intended to cover personal service organizations of the character of a professional corporation:

[T]he [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 P.H.C. income.\(^6\)

Because there may be some risk of confiscatory taxes on retained personal-holding-company income\(^6\) or penalty taxes on retained earnings and profits beyond the reasonable needs of the business,\(^6\) the corporation may determine that its most feasible course of action is to distribute any potential excess income to its professional employees in the form of higher salaries by a percentage-bonus arrangement.\(^6\) If the recipient

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\(^6\) For example, a client or patient often is not or cannot be particular about which doctor or lawyer in a partnership performs the services. However, when a sole professional incorporates, he is the only the professional employee available to render the necessary services, and the right of designation is automatic. Thus the corporation with a sole professional employee will almost certainly meet the tests of a personal holding company. *E.g.*, Kurt Frings Agency, Inc., 42 T.C. 472 (1964), aff'd 351 F.2d 951 (9th Cir. 1965) (personal-holding-company status found when actor-clients of one-man artist's representative corporation relied on owner's personal reputation, skill, and contacts).


\(^{65}\) H.R. REP. No. 1546, 75th Cong., 1st Sess. 5-6 (1937). See also S. REP. No. 1242, 75th Cong., 1st Sess. 7-8 (1937).

\(^{66}\) CODE § 541.

\(^{67}\) Id. § 531.

\(^{68}\) Under Treas. Reg. § 1.162-9 (1958), the IRS recognizes bonuses to employees as allowable ordinary and necessary business expenses of a corporation under CODE § 162 when such payments are made in good faith and as additional compensation for services actually rendered. But such payments when added to the stipulated
professional employees are shareholders who are in control of the corporation's affairs and decisions, the IRS is justified in closely scrutinizing the distributions to determine if the so-called "bonus compensation" for services rendered is in reality a disguised dividend.60 A percentage bonus arrangement with all shareholder-employees that is contingent on excess corporate income after the corporate base salaries and expenses have been deducted may tend to be reasonable compensation, but payments under such an agreement could be attacked as constructive dividends.60 Despite this possibility, a challenge for unreasonable compensation probably will not occur if the corporation does not realize substantial income from sources other than the rendering of personal services by its professional employees.71

2. Disregard of the Corporate Entity

The shareholder-employees of professional corporations face an additional, albeit vague, limitation under Code section 269, which prohibits the acquiring of a corporation for the principal purpose of avoiding or evading taxes by securing benefits of deductions, credits, or other allowances that the shareholder-employees would not have otherwise en-

salaries must not exceed a reasonable compensation for the services rendered by the recipient. If such a bonus is found to be legitimate compensation, it seems logical to presume that a percentage of the bonus can be contributed by the employer to a pension plan. See Code § 404(a)(3).

See Northlich, Stolley, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966). Obviously the IRS would prefer to have bonus payments, deductible by the corporation under Code § 162 if they are reasonable compensation, treated as constructive dividends, which are not deductible by the corporation. See Treas. Reg. § 1.162-7 (1958). If the corporation pays taxes on the payments as distributed dividends, the payments will also be taxed to the individual as income. Thus the dividends will be subject to the disadvantage of double taxation.

In Irby Constr. Co. v. United States, 290 F.2d 824, 827 (Ct. Cl. 1961), the court pointed out that a "bonus-type contract which is reasonable with a non-stockholder employee may be unreasonable if made with a large stockholder, since the incentive of the bonus would presumably not be needed to call forth the stockholder's best efforts." See Treas. Reg. §§ 1.162-7 & -8 (1958), which indicate that it is extremely likely that the IRS would seek to treat as dividends any "bonus" distributions made pro rata with respect to stock ownership. See also Treas. Reg. § 1.301-1(c).

joyed. This statutory limitation, in addition to Code section 482 allowing the IRS under given circumstances to allocate income or deductions between two or more businesses controlled by the same taxpayer, is more or less a codification of the judicial doctrines disregarding a corporate entity when it is a sham or has no real business purpose. However, if the professional corporation actively engages in business and renders services to the public, pays due respect to the "niceties" of corporate procedure and law, and does not attempt to split the single entity into multiple entities, then the IRS would be unlikely to succeed in

Although Code § 269 refers to an "acquisition" of a corporation and is usually confined to corporate reorganizations or the establishment of multi-corporations in place of one, the provision can apply to the original creation of a corporation by a transfer under Code § 351. See Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960); Coastal Oil Storage Co. v. Commissioner, 242 F.2d 396 (4th Cir. 1957). See also Treas. Reg. § 1.269-3(b) (1962).

The sanction for violating Code § 269 is the disallowance of the deduction, credit, or other allowance. Code § 269(a). However, the applicability of Code § 269 to original incorporation by a former partnership is rendered extremely questionable by Code § 269(c), which raises a presumption that Code § 269 is applicable in case of a disproportionate purchase price for the acquired entity. Obviously there can only be a disproportionate purchase price if the corporation had been in existence prior to the acquisition, and this situation is unlikely in the case of professional corporations.

See, e.g., Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968).

E.g., Advance Mach. Exch., Inc. v. Commissioner, 196 F.2d 1006 (2d Cir.), cert. denied, 344 U.S. 835 (1952); Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940); Shaw Constr. Co., 35 T.C. 1102 (1961); Aldon Homes, Inc., 33 T.C. 582 (1959). See BITTKE § 13.32, at 680. The sham-corporation treatment has usually been restricted either to entertainers who incorporate or to the establishment of multi-corporations in place of one. If the corporation is regarded as a sham, its income is taxed to the shareholders.

E.g., Pauline W. Ach, 42 T.C. 114 (1964), aff'd, 358 F.2d 342 (9th Cir. 1966); Arthur T. Beckett, 41 T.C. 386 (1963).

The decisions recognizing the validity of professional corporations for tax purposes have emphasized the observance of such practices as making formal corporate contracts with professional employees, billing the client or patient in the name of the corporation, having bank accounts in the corporate name, and having regular meetings of the board of directors and shareholders. A loan to the corporation by an outside creditor without his requiring a shareholder's indorsement is good evidence of independent corporate existence. E.g., Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969); United States v. Empey, 406 F.2d 157 (10th Cir. 1969); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968). Failure to observe these formal practices can have serious tax consequences. See Jerome Roubik, 53 P-H Tax Ct. Rep. § 53.36 (Dec. 12, 1969) (holding a corporation formed by a group of doctors a sham because there were no corporate assets and usual corporate records were not kept).

Some professionals may decide either to form or to maintain an existing separate leasing corporation to provide the capital assets and possibly the services of non-professional employees for the professional corporation. However, the IRS
attacking the corporation with these statutory or judicial weapons. 78

3. The Professional Corporation with One Shareholder-Employee

Notwithstanding the unanimously favorable judicial decisions recognizing the validity of professional corporations 79 and the Treasury's acquiescence in those decisions, 80 the sole professional who wishes to incorporate and derive the benefits of being treated as an "employee" of his corporation is faced with perplexing statutory and judicial obstacles. No case has involved a professional corporation with only one shareholder-employee, 81 and the IRS has not expressly conceded the validity of this type of professional corporation. 82 Nevertheless, if the courts adopt Morrissey's "resemblance test" 83 as determinative of whether a professional corporation will in fact be accepted as a corporation for federal tax purposes and reject the state label of "corporation" as decisive, 84 a professional corporation with a sole shareholder-employee probably would qualify. 85 But even if the organization with one shareholder does qualify

may attack one or both of the corporations under Code §§ 1551, 482, or 269, especially if the stock of both corporations is owned pro rata by the shareholder-employees. In addition, any pension or profit-sharing plan would almost certainly be attacked as discriminatory if the leasing corporation did not have a suitable and comparable deferred compensation plan for its non-professional employees. See Code §§ 401(a)(3) & (5); Treas. Reg. §§ 1.401-3, 4 (1963).

78 See Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-39 (1943), in which the Court stated: "Whether the purpose be to gain an advantage under the law of the state of incorporation... so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." See also O'Neill v. United States, 410 F.2d 888, 891 (6th Cir. 1969).

79 See note 12 supra.
80 See note 3 supra.
81 In Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969), the professional corporation had only two shareholder-employees.
82 In T.I.R. 1019 (Aug. 8, 1969) reprinted in P.H. 1969 FED. TAXES, INCOME ¶ 55.334 (Aug. 14, 1969), the IRS conceded the general validity of professional corporations organized under state statutes similar to those in Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969) and United States v. Empey, 406 F.2d 157 (10th Cir. 1969), but it reserved the right to contest any professional corporation under special circumstances not present in either of these cases.
83 See note 8 and accompanying text supra.
84 E.g., Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969). This opinion is probably the best and most thoroughly reasoned one concerning professional corporations.
85 A sole shareholder-employee of a professional corporation will find that his liability usually is limited only with respect to corporate debts. N.C. GEN. STAT. § 55B-9 (Supp. 1969). But this situation is not unlike that faced by any sole shareholder-employee of any business corporation. With respect to continuity of interest, if the sole shareholder dies, the corporate entity will continue to exist,
as a corporation under the Code, the unfortunate sole professional is
still faced with additional tax limitations.

In order to enjoy the various non-taxable fringe benefits, such as
a qualified deferred compensation plan, the sole professional who in-
corporates must qualify as an employee of his corporation, not as a self-
employed individual. Although the IRS has adopted the general
common law test of control as determinative of whether a particular person
is an employee of another, the only definition of an employee found in
the Code is in section 3401(c), which deals with an employer's witholding
of an employee's taxes. This section states: "For purposes of this
chapter, the term 'employee' includes . . . an officer of a corporation."
The Treasury Regulations also provide that "generally, an officer of
a corporation is an employee of the corporation." This statement is
presumably qualified by the language: "However, an officer of a corpora-
tion who as such does not perform any services or performs only minor
services and who neither receives nor is entitled to receive . . . any
remuneration is not considered to be an employee of the corporation." Finally, the regulations state that "an employer may be an individual, a
corporation . . . ." From the literal language of the Code and the
accompanying Treasury Regulations, it would appear that the sole pro-
fessional could incorporate, become an officer of his corporation, be
treated as an employee of the corporation, and thus be qualified for non-
taxable fringe benefits.

although only for a limited time unless some other person is willing and able
to carry on the business. Id. § 55B-7 (Supp. 1969). Transferability of shares in
the corporation is restricted only in the sense that the transferee must be a licensed
professional, a limitation not unlike those accomplished by agreements among
shareholders in close corporations. Id. § 55B-6 (Supp. 1969). Management, of
course, is inherently centralized in the sole shareholder-employee although he may
have other licensed professionals on his board of directors.

Under Morrissey's "resemblance test" as applied in Kurzner v. United States,
413 F.2d 97 (5th Cir. 1969), the professional corporation controlled by a sole
shareholder-employee would almost certainly qualify as a corporation under the
Code. It would possess at least two and probably three of the four requirements
established in Morrissey. The court in Kurzner emphasized that if the pro-
fessional corporation under scrutiny closely resembles traditionally recognized
corporations, to treat it differently from the others would be arbitrary and dis-
criminatory. 413 F.2d at 111.

86 Cf. Code § 7701(a) (20).
87 Treas. Reg. § 31.3401-1(b) (1957).
88 Treas. Reg. § 31.3401(c)-1(f) (1957).
89 This qualification would not be relevant to the sole professional who incorpo-
rates and continues his practice.
90 Treas. Reg. § 31.3401(d)-1(c) (1957).
However, if the common law test of control pre-empts Code section 3401(c) in determining whether an officer is an employee of a corporation in a given case, it would seem that the sole shareholder-employee of a professional corporation would have to be considered an “independent contractor” since he has complete control of himself. But if the common law test is really applicable in determining the status of every employee of a corporation, Code section 3401(c) is mere surplusage. Therefore, it seems logical to assume that this provision should be read to include as an employee of a corporation any active officer, regardless of whether that officer is also the sole shareholder-employee.\textsuperscript{91}

Even if the IRS concedes that the sole shareholder of a corporation can be an employee for federal tax purposes, it still has available the statutory weapons of Code sections 269 and 482 and the judicial precedents regarding sham corporations and those that lack a real “business purpose.”\textsuperscript{92} Undoubtedly, the IRS has a better chance of success against one-shareholder professional corporations than against the ones having two or more shareholder-employees.\textsuperscript{93} Highly-paid entertainers, who have attempted to incorporate their talents in order to avoid taxes in one way or another, have consistently been victims of successful attacks.\textsuperscript{94}

In \textit{Borge v. Commissioner},\textsuperscript{95} an entertainer bought a chicken farm that was destined to lose money for a few years. The entertainer incorporated the farm, contracted his service to the corporation for a salary substantially less than their worth, and the corporation sold his services at a high profit, which it off-set against its losses on the chicken farm. The IRS was successful in its challenge to both the entertainer and his corporation under Code sections 269 and 482.\textsuperscript{96} Notwithstanding \textit{Borge} it is highly unlikely that the courts will distinguish between the sole professional who incorporates and controls himself and the payment of his wages and any other individual owner of a regular business who incorporates and becomes the controlling shareholder.\textsuperscript{97} See notes 72-78 and accompanying text \textit{supra}.\textsuperscript{98} If for no other reason, the courts will not be reluctant to disregard the corporation if the sole shareholder-employee is guilty of disregarding it himself in the course of his business.\textsuperscript{99}

\textit{E.g.}, \textit{Borge v. Commissioner}, 405 F.2d 673 (2d Cir. 1968); United States v. Johannson, 336 F.2d 809 (5th Cir. 1964); Laughton v. Commissioner, 113 F.2d 103 (9th Cir. 1940).\textsuperscript{100}

\textit{405 F.2d 673} (2d Cir. 1968).

\textit{Under Code § 269} the IRS can refuse “a deduction, credit or other allowance” that the taxpayer would not have otherwise had if he has an improper motive in acquiring the corporation. Does “other allowance” mean “income” that is not included in an employee’s gross income, such as an employer’s contribu-
and similar results in other cases, it is perfectly proper for an individual to arrange his business affairs so as to minimize taxes. In cases in which the IRS has successfully attacked a personal-service corporation under sections 269 or 482 or under the theory that it is a sham, it has been evident that the corporation existed not to serve a corporate business purpose but merely to serve a shareholder's purpose in evading taxes. And, as in Borge, there was usually a sole stockholder involved who attempted by some device to derive indirectly a tax benefit from his position as a shareholder.

As long as the sole professional who incorporates does not contract his services to the corporation at substantially less than their value, there seems to be no reasonable justification for treating him any differently for tax purposes from any other sole owner-employee of any incorporated business conducting bona fide operations. Furthermore, every court that has recognized the existence of the professional corporation has emphasized that it must be treated no differently by the IRS than any other close business corporation.

III. Principal Corporate Advantages and Limitations

The corporation is, with all things considered, a "utilitarian vehicle for conducting business affairs; it is more manageable in connection with estate planning and probate than either partnerships or proprietorships; and it is potentially as convenient for professional activity as for ordinary business." The North Carolina Professional Incorporation Act represents a tacit legislative rejection of the traditional common law and statutory prohibitions against the practice of a profession to a qualified pension plan? Such a fringe benefit is not a "deduction" under the Code. See, e.g., Code § 105(d).

E.g., Ach v. Commissioner, 358 F.2d 342, 343 (9th Cir. 1966).

E.g., Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969). The judicial implications have been clear: if the corner hardware store, incorporated and totally owned by "Mr. Business," is to be treated as a "corporation" under the Code, then so is a personal-service corporation solely owned and operated by "Mr. Professional."


E.g., Parker v. Panama City, 151 So. 2d 469 (Fla. App. 1963) (in the absence of express statutory authority, a corporation cannot lawfully engage in the practice of a learned professional).

by the corporate entity, prohibitions generally thought to be based on the essentially personal relationship existing between the lawyer and his client, or the doctor and his patient. With respect to both law and medicine, the noncorporate status of practitioners was often thought necessary in order to preserve for the client or patient the benefit of a highly confidential relationship, based upon personal confidence, ability, and integrity.\textsuperscript{103} However, it hardly seems tenable that corporate status could materially affect the desired relationship between the professional and the person to whom he renders services.\textsuperscript{104} Moreover, present realities have cast grave doubts on the validity of the reasons supporting the traditional prohibitions against professionals operating within a corporate structure.

The public demand for more and better-trained professionals is increasing at a rate exceeding the limited output. As pointed out by Senator Percy in a speech before the Senate,\textsuperscript{105} equal corporate tax treatment of the professional corporation will necessarily encourage many professionals to utilize the corporate vehicle in their practice. And, according to Senator Percy, the tax and operational characteristics of a corporation, as opposed to those of the traditional partnership, will afford medical, legal, and other professionals an opportunity to make more efficient and economical use of multi-speciality group practices. The ultimate beneficiary of more efficient group or team practice would be the average citizen whose needs demand more efficient professional aid.\textsuperscript{108}

The North Carolina Professional Incorporation Act incorporates the provisions of the Business Incorporation Act,\textsuperscript{107} but provides express limitations necessary to assure the continuing integrity of the professions.\textsuperscript{108} The Act endows the professional corporation with characteristics that not only should distinguish the corporate entity from the traditional

\textsuperscript{103} \textit{In re} Florida Bar, 133 So. 2d 554 (Fla. 1961).
\textsuperscript{104} Both the American Bar Association and the American Medical Association have taken the position that it is not unethical for their members to organize in the form of a professional association or corporation. But the American Institute of Certified Public Accountants has said that one of its members may not be "an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting." H. Jones, \textit{Professional Corporations 32} (PLI, Tax Law and Practice Course Handbook Number 14, 1969).
\textsuperscript{108} Id. §55B-3 (Supp. 1969). The Act also vests a general power in the licensing board of each profession to regulate its licensees in respect to any rules or regulations that it may adopt regarding their right to incorporate.
partnership for tax purposes, but that also afford the entity with operational advantages not found in the traditional partnership. 100

A. Continuity of Existence and Transferability of Interest

Unlike the traditional partnership, the professional corporation will possess a continuity of existence despite the retirement or death of a shareholder. 110 Important to the advantage of continuity of existence is the transferability of a shareholder's stock. Transferability of ownership is limited by the Act only in the sense that any transferee of a stockholder's shares must be a duly licensed professional in the profession practiced by the corporation. 111 The continuing existence of the corporation together with the ability of a shareholder to transfer ownership makes it possible for the professional to enter into an equitable shareholder buy-sell or corporate redemption agreement.

Naturally the loss to a personal-service corporation of a withdrawing shareholder would necessarily tend to reduce the earning capacity of the corporation more than would be the case for a typical business with substantial income-producing physical assets. Thus withdrawal of a professional from the corporation would also reduce the value of the stock to be redeemed or purchased by another shareholder or licensed outsider. But as most likely will be the case, the withdrawing shareholder would probably have contributed substantial goodwill to the corporation in leaving behind clients or patients who will continue to employ its services. In order to insure the most equitable realization of the value of such goodwill both to the corporation and to the withdrawing shareholder, the Act provides for the possibility of the continuing use of his name in the official corporate title. 112 The Act further protects the

100 Some of the characteristics required for tax purposes that were established in Morrissey v. Commissioner, 296 U.S. 344 (1934), such as continuity of life, free transferability of interests, and centralization of management, can be achieved in “modern” partnership agreements. However, these characteristics are not only cumbersome and sometimes legally uncertain when achieved by a partnership agreement, but they also endow the partnership with traditional corporate characteristics that could result in treatment of the partnership as a corporation for tax purposes.

110 N.C. GEN. STAT. § 55B-7 (Supp. 1969). The continuity of existence is possible even if the professional corporation has only one licensed shareholder so long as a licensed professional of the same profession becomes the transferee of the shares.

111 Id. § 55B-6.

112 Id. § 55B-5. Both the North Carolina Board of Medical Examiner’s regulations and the regulations of the Council of the North Carolina Bar provide for the preservation, upon proper authority, of a withdrawing bona fide shareholder's
interest of a shareholder who has died by requiring, in the absence of an agreement determining the equitable value of his shares, that the corporation redeem them at their fair market value, but in no case will the redemption price be less than the book value as of the month immediately preceding his death.\footnote{1}

\section*{B. Centralization of Management}

An additional advantage obtained through the corporate structure that is not always possible in the traditional partnership is centralization of management achieved because the shareholders can vote and elect their directors. However, the Act specifically prohibits any stockholder of the corporation from entering into a voting-trust arrangement or any other type of agreement vesting in another person the authority to exercise the voting power of any or all of the shareholder's stock.\footnote{4} Presumably the intent of the prohibition is to prevent shareholders from vesting their voting rights in a nonprofessional. But the effect of this provision seems to be unnecessarily over-reaching since it apparently prohibits voting agreements among shareholders, which are permissible under the general Business Corporation Act.\footnote{115}

\section*{C. Limited Liability of the Shareholder-Employee}

The final principal advantage to be acquired by professionals operating within the corporate form is that of limited liability to the shareholders. The Act provides:

\begin{quote}
Nothing in this chapter shall be interpreted to abolish, modify, restrict, limit or alter the law in this state applicable to the professional relationship and liabilities between the person furnishing the services and the person receiving such professional services, or the standards of professional conduct applicable to the rendering therein of such services.\footnote{116}
\end{quote}

Since a professional employee performing services is, as any corporate employee, personally liable for his wrongful acts under the common law, name. In addition, the Council of the North Carolina Bar in its regulations requires the use of at least one shareholder's surname in the corporate name (North Carolina Bar Regulations of Professional Corporations, Rule 2.1, 1969). The Board of Medical Examiners' regulations do not (Board of Medical Examiners' Regulations of Professional Corporations, Rule II-3, 1969).

\footnote{113} N.C. GEN. STAT. § 55B-7(b) (Supp. 1969).
\footnote{114} Id. § 55B-6.
\footnote{115} See id. § 55-73 (1964).
\footnote{116} N.C. GEN. STAT. § 55B-9 (Supp. 1969).
this provision could have been intended to preserve possible vicarious liability of a physician employed by a professional corporation for the negligence of nonprofessional corporate employees under his control. The provision also arguably preserves any personal contractual liability of a professional employee for failure to produce a promised result although employees of nonprofessional corporations are not liable for corporate contracts. Since the statutory language refers only to the person who furnishes and the person who receives services, the necessary implication is that stockholders of the corporation enjoy the advantages of limited liability in their capacity as shareholders.\footnote{See O'Neill v. United States, 281 F. Supp. 359, 361-62 (N.D. Ohio 1968), aff'd, 410 F.2d 888, 898 (6th Cir. 1969), which applied this same interpretation to the limited-liability section of the Ohio Professional Association law, \textit{Ohio Rev. Code} 1785.04 (Supp. 1961). The Ohio law is identical to the limited-liability section of the North Carolina Professional Corporation Act, \textit{N.C. Gen. Stat.} § 55B-9 (Supp. 1969). \textit{See also Ga. Code Ann.} § 84-4307 (Supp. 1961).}

\section*{IV. Conclusion}

Tax advantages are certainly the most important incentives to forming a professional corporation, but it is doubtful that tax laws covering some of the employee fringe benefits, especially the pension and profit-sharing plans, will remain as attractive in the future. Regardless of whether a professional entity operates as a partnership or a corporation, its capacity to generate income generally would be the same. Since the employee fringe benefits are not "free," the professional usually would have to accept less take-home pay in order to derive an advantage from them. As a result of the necessity of the professional corporation carefully to conduct its business as a corporate entity to withstand the close scrutiny of the IRS, operational expenses for the smaller corporation likely would be greater than for a partnership of the same size.

The corporate characteristics of continuity of existence and free transferability of interest can facilitate the estate planning of a shareholder. While formal centralization of management may be an important factor in achieving greater operational efficiencies in the larger professional entities, in smaller practices centralization could be burdensome and undesirable. Although liability appears to be limited to a significant degree, the possibility of the realization of this advantage is unlikely because most corporations will find it safer to acquire sufficient liability insurance. And, except for the attribute of limited liability, the effects of traditional