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Federal Tax Status of California Professional Men Who Incorporate

by Stephen A. Lind*

As of November 13, 1968, certain types of California professional men (including lawyers)¹ are permitted to incorporate their practices under the Moscone-Knox Professional Corporations Act.² Acts which are similar to the California provisions have been passed in a substantial majority of the states.³ The decision whether to incorporate presents a perplexing problem to lawyers and other classes of professionals who are allowed to incorporate. There are numerous advantages and disadvantages of incorporation which must be weighed in making the decision.⁴

The federal tax consequences of incorporation are probably the most important factor to consider in determining whether to incorporate.⁵ However

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¹ Under the California provisions the following types of professional men are allowed to incorporate: dentists, doctors, lawyers, osteopaths, and podiatrists.

² The Moscone-Knox Professional Corporation Act is specifically §§13400-13410 of the Corporations Code. It is only a part of Senate Bill 53 (Stats. 1968, ch. 1375) which also provides for the addition to the Business and Professions Code of §§1800-08; 2008.5; §§2500-08; §6127.5; and §§6160-72. The Bill also amends §23038 of the Revenue and Taxation Code and §954 and §994 of the Evidence Code.


⁴ Foremost among the non-tax considerations in an incorporation are the following: the question of limited liability; various procedural requirements which must be met in the act of incorporating; and various formalities which must be complied with in operating as a corporation. See Comment, 75 HARV. L. REV. 776, 785 (1962).

⁵ The fact that the professional man has incorporated his services means that he is an employee rather than a self-employed person under the Internal Revenue Code of 1954. With the classification of employee there are various tax benefits which become available: (1) the use of pension and profit sharing plans under Internal Revenue Code §§401-07 and §501 which have numerous tax deferring and recognizing advantages over the self-employed provisions of H.R. 10 (The Keogh Act) (Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. 87-792, 76 Stat. 809 (codified in scattered sections of 26 U.S.C.)); (2) the use of various health plans and sick pay provisions under Internal Revenue Code §§104-06; (3) the use of Internal Revenue Code §101(b) allowing a corporate tax deduction of a $5000 death benefit to an employee's estate which is tax free to the estate; (4) the use of group life insurance plans up to $50,000 with consequences similar to the death benefit above under Internal Revenue Code §79.

There are other tax benefits of incorporation in the areas of tax accounting, the Internal
ever, before an entity may use the corporate tax consequences, it must first be classified as a corporation under the Internal Revenue Code. The question of whether a California Professional Service Corporation will be given corporate status for federal tax purposes is therefore of great importance in making the decision whether to incorporate and is the topic of this article.

The Commissioner has been very reluctant if not hostile toward granting corporate status to professional groups. This reluctance has been manifested through various scare techniques and through the regulations to the Internal Revenue Code. In fact, in 1965 the Treasury Department promulgated §301.7701-2h of the Treasury Regulations (hereafter referred to as the professional services regulations) in which it singled out professional service organizations and imposed stringent standards which such organizations must meet in order to be classified as corporations for federal tax purposes. The professional service organization regulations have been the subject of much recent litigation. This article will attempt

Revenue Code §243 dividends received credit, the tax imposed on the corporate entity under Internal Revenue Code §11 (which may be advantageous).

While there are various tax advantages of incorporation there are tax disadvantages as well. The taxation at both the corporate and individual level may work a disadvantage (note that this consequence may be avoided by an election under Subchapter S Internal Revenue Code §§1371–1378). There are also several types of tax traps which threaten the corporate entity such as Personal Holding Company problems (Int. Rev. Code of 1954 §541 et seq.), Collapsible Corporation problems (Int. Rev. Code of 1954 §341) and the problem of unreasonable salaries.


The definition of a corporation for purposes of the Internal Revenue Code is found in §7701(a)(3) which in rather broad terms states: "The term 'corporation' includes associations, joint stock companies, and insurance companies."

The term "scare techniques" is used to point out that the Service's attitude in this area until recently has been one of silence, delay, and failure to litigate. These tactics would appear to be for the purpose of creating taxpayer uncertainty and scaring taxpayers away from the use of professional service corporations. For a detailed study of the Service's tactics see Eaton, Professional Corporations and Associations in Perspective, 23 Tax L. Rev. 1, 21 (1967–1968).


to determine the validity of those regulations and to advise California professional men of their chances of being recognized as valid corporations for federal tax purposes if they decide to incorporate under the Moscone-Knox Act.

I

HISTORY

A brief history of the area of classifying organizations for federal tax purposes will aid in putting the problem into perspective. An important element to be aware of is that the Commissioner’s position in this area has been very inconsistent and had forced him into a situation which has been aptly described as “unenviable.”

The problem involved is determining whether a business organization should be classified as a “corporation” or as a “partnership” or some other taxable entity such as a “trust.” This distinction between various types of taxable entities dates back to early code provisions. The problem is created by the very broad definitional provisions in the code. Section 7701 (a) (2) defines a “partnership” to include “a . . . group, . . . joint venture, or other unincorporated organization . . . which is not, within the meaning of this title, a trust or estate or a corporation.” It is followed by §7701 (a) (3) which states: “The term ‘corporation’ includes associations, joint-stock companies, and insurance companies.” Thus Congress has provided vague definitions for classifications upon which very important tax consequences depend.

Although Congress has been vague in this area, nevertheless, the courts have been somewhat helpful in clarifying it. The only case in this area which the Supreme Court has decided is Morrissey v. Commissioner and in that case it established the corporate resemblance test which has become an important doctrine in the area. The Morrissey case involved a trust which was actively engaged in carrying on a business enterprise. The

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11 See supra note 6. See also supra note 5 for the tax consequences on corporate classification.
Commissioner contended that even though it was formed as a trust, in reality it resembled a corporation and ought to have been classified as an "association" and have corporate tax consequences. It should be noted that the Commissioner was arguing to tax the organization as a corporation. The Supreme Court agreed with the Commissioner's position and stated that since the trust had several characteristics similar to a corporation it more resembled a corporation than a trust and even though it was not identical to a corporation it sufficiently resembled one to be so taxed. The Court pointed out that the trust entity was capable of holding legal title and that it was embarked in a corporate undertaking. The Court then found that the trust had the following corporate characteristics: (1) it had a continuity of the enterprise even in the event of death of the owners; (2) it had centralized management; (3) its liability extended only to the property embarked in the undertaking and not out to the participants; and (4) its interests could be transferred without affecting the continuity of the enterprise.

The Morrissey corporate resemblance test was first applied to a group rendering professional services in the case of *Pelton v. Commissioner*. In *Pelton* the Seventh Circuit applied the test to determine that a group of Illinois physicians who were organized as a business trust resembled a corporation and consequently ought to be taxed as one. This result was reached even though the state Supreme Court had concluded that physicians would not be allowed to incorporate within the state. In the *Pelton* case the government again urged that the group be treated as a corporation rather than a trust in order to be able to tax their income both at the corporate and individual levels. The Commissioner was satisfied with his victories and issued orders for the Service to use the corporate resemblance test to tax such entities including professional groups as corporations.

After the *Pelton* decision, professional men became aware of some of the possible tax advantages of being taxed as a corporation. With that awareness, the positions of professional men and the Service were completely reversed with the government contending that groups of professional men should not be classified and taxed as corporations. The first

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16 The case relied on §2(a)(2) of the 1924 and 1926 Internal Revenue Codes which, like the 1954 Internal Revenue Code, included "associations" within the term corporation.
18 82 F.2d 473 (7th Cir. 1936).
19 People v. United Medical Services, 362 Ill. 422, 200 N.E. 157 (1936).
21 See supra note 5.
case after the reversal of positions was United States v. Kintner. In the Kintner case a group of Montana physicians attempted to set up an association in order to take advantage of the code's pension provisions applicable to corporations, even though in Montana, as in Illinois, physicians were not permitted to incorporate. The Commissioner in a complete reversal from his Pelton position argued that due to the personal nature of the services rendered by physicians, groups of physicians could not be classified as corporations for federal tax purposes. The Ninth Circuit relying on the Pelton decision, rejected the Commissioner's argument and held that the physicians had corporate status. A similar result was reached in a 1959 case involving a group of Texas physicians.

It is notable that in the above cases two judicial trends developed. First, the courts in treating the organizations as corporations for Federal tax purposes placed little or no importance on the fact that under state law groups of professionals could not be incorporated. Second, the courts appeared to be rather lenient in permitting corporate classifications by requiring characteristics merely resembling a corporation rather than characteristics identical to a corporation.

In November, 1960, the Treasury Department issued a new set of regulations in an attempt to counter the above results and to halt the spread of professional associations. This set of regulations has been labelled the Kintner regulations, although they might well have been called the anti-Kintner regulations since they are an attempt to reverse the Kintner decision. The regulations use the Morrissey corporate resemblance test and its characteristics but define the various corporate characteristics in more detail. Although the regulations deal primarily with whether an

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22 216 F.2d 418 (9th Cir. 1954).
24 The Commissioner based his personal nature of services argument on his prior victory in Mobile Bar Pilots Association v. Commissioner, 97 F.2d 695 (5th Cir. 1938). The court in Kintner distinguished the Kintner situation from the Pilots case. United States v. Kintner, 216 F.2d 418, 424 (9th Cir. 1954).
26 This was the case in the Pelton, Kintner, and Galt cases. In the Galt case the court stated: "The act of a state can neither raise nor lower the federal taxes that may be due by the association by whatever name it may be called under the laws of the particular state." Galt v. United States, 175 F.Supp. 360, 362 (N.D. Tex. 1959).
27 The Morrissey case stated: "The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity." 296 U.S. 344, 357 (1935).
29 The Kintner regulations define the characteristics of corporate entities as: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate
unincorporated entity should be given corporate status, nevertheless, there was some indication that they should be applied as well to determine whether an entity which has corporate status within a state should be classified as something other than a corporation for federal tax purposes.\textsuperscript{30}

Since the \textit{Kintner} regulations were an attempt to place various non-corporate organizations into other than corporate tax status, the regulations have some provisions to carry out that result. The regulations put heavy emphasis upon the importance of local law and the classification of organizations under local law.\textsuperscript{31} Also in an attempt to fit organizations into a noncorporate classification the regulations provide that doubtful organizations be given noncorporate status by requiring them to have a majority of corporate characteristics in order to obtain corporate classification.\textsuperscript{32} However, it is notable that under the \textit{Kintner} regulations as they were originally enacted, there was an example under which most of today's professional associations would have been treated as corporations.\textsuperscript{33}

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\textsuperscript{30} This point is made in Comment, 75 Harv. L. Rev. 776, 784 (1962) which quotes Treas. Reg. §301.7701-1(C) (1960 regulations): "A particular organization might be classified as a trust under the law of one State and a corporation under the law of another State. However, for purposes of the Internal Revenue Code, this organization would uniformly be classed as a trust, an association (and, therefore, taxable as a corporation), or some other entity, depending upon its nature under the classification standards of the Internal Revenue Code."

\textsuperscript{31} Treas. Reg. §301.7701-1(C) (1960). The regulations state that local law is important in determining the characteristics of an entity. It has been pointed out that under the scope of the 1960 regulations any partnership in a state where the Uniform Partnership Act is in effect could not be classified as an association. Eaton, \textit{Professional Corporations and Associations in Perspective} 23 Tax L. Rev. 1, 7 (1967).

\textsuperscript{32} Treas. Reg. §301.7701-2(a)(3) (1960). It should be pointed out that in most current disputes over classification of such organizations the question is whether they are corporate entities or non-corporate entities in the form of partnerships.

\textsuperscript{33} Treas. Reg. §301.7701-2(g) Example 1 (1960) states: "Example (1). A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any individual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion of a member shall cause the dissolution of the organization. Under the applicable local law, on the occurrence of such an event, no member has the power to dissolve the organization. The management of the clinic is vested exclusively in an executive committee of four members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Members of the clinic are personally liable for all debts of, or claims against, the clinic. Every member has the right to transfer his interest to a doctor who is not a member of the organization, but he
Since the 1960 \textit{Kintner} regulations had put an emphasis upon the classification given an organization by the states, this implied that if a state incorporated an organization then the regulations would seemingly recognize that status for federal purposes. Consequently there was a movement by professional groups to have state legislatures pass bills to allow them to incorporate. A substantial majority of the states have enacted legislation similar to the California Professional Corporations Act granting corporate status to professional men.\textsuperscript{34}

In an attempt not to be outdone by the professional men in this seesaw battle, and in a further attempt to deny professionals corporate tax status, the government in 1965 again pulled a partial reversal of its attitude. In that year the Treasury Department promulgated a special set of regulations within the context of the \textit{Kintner} regulations to deal specifically with professional service organizations. The 1965 revisions made the following changes:

(1) They again de-emphasized the importance of state labels as controlling for purposes of classifying an organization for federal tax consequences.\textsuperscript{35} By this action they hoped to overcome the fact that professionals had been granted corporate status by the states.

(2) They eliminated the example pointed out above which followed the \textit{Kintner} and \textit{Galt} cases and under which today's professional groups would be granted corporate status.\textsuperscript{36}

(3) They stated that professional service organizations are "inherently different"\textsuperscript{37} from ordinary business corporations and they consequently promulgated a new set of rules under §301.7701–2h applicable specifically to professional service organizations.\textsuperscript{38}

In summary although the rules use the same set of characteristics as the regular \textit{Kintner} regulations, nevertheless, they redefine those characteristics in such a way as to make it extremely difficult for any professional service organization to be granted federal corporate tax status.

must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While it does not have the corporate characteristic of limited liability, it does have the characteristics of centralized management, continuity of life, and a modified form of free transferability of interests. The organization will be classified as an association for all the purposes of the Internal Revenue Code."

\textsuperscript{34} See supra note 3.
\textsuperscript{35} Treas. Reg. §301.7701–1(c) (1965).
\textsuperscript{36} Treas. Reg. §301.7701–2(g) Example 1 (1960).
\textsuperscript{37} Treas. Reg. §301.7701–2(h) (1)(ii) (1965).
\textsuperscript{38} Treas. Reg. §301.7701–2(h) (1965).
Thus prior to the enactment of the 1965 regulations the Service due to its seesaw attitudes found itself in an "unenviable"\textsuperscript{30} position. The Service attempted to salvage the situation with its 1965 criteria for characterization of professional service groups. With respect to those criteria a recent case has stated:

It cannot be doubted that except for the most unusual circumstances, these criteria preclude all professional service organizations from achieving corporate status.\textsuperscript{40}

The question of whether professional service corporations, including those incorporated under the California Act, will be classified as corporations for federal tax purposes is largely dependent upon the validity of the 1965 regulations.

II

THE CASES TESTING THE PROFESSIONAL SERVICES REGULATIONS

Professional men who have incorporated under the various state professional services corporations acts have greeted the government's professional services regulations with obvious hostility. To date there have been five cases testing the validity of the government's 1965 regulations,\textsuperscript{41} and these cases have unanimously held the regulations to be invalid. Several cases are currently on appeal to the Circuits,\textsuperscript{42} and it is reported that the Tax Court will soon have its first opportunity to determine the status of the regulations.\textsuperscript{43} The decided cases have invalidated the professional services regulations under two different lines of reasoning: (1) The state label rationale: these cases essentially conclude that once a state labels an organization as a corporation it is (automatically) excluded from the Internal Revenue Code definition of a partnership which is limited to "unincor-

\textsuperscript{30} See text accompanying note 10. The rationale for that statement is further exemplified by the fact that in 1964 the District Court of Florida followed the Kintner and Galt decisions in a case involving a group of doctors in Florida in which the court granted them federal corporate tax status. Foreman v. United States, 232 F.Supp. 134 (S.D. Fla. 1964).

\textsuperscript{40} Kurzner v. United States, 286 F.Supp. 839, 844 (S.D. Fla. 1968). (currently on appeal to 5th Circuit.)

\textsuperscript{41} See supra note 9.

\textsuperscript{42} The Holder and Kurzner cases are being appealed to the Fifth Circuit Court of Appeals and the O'Neill case is currently on appeal to the Sixth Circuit Court of Appeals.

\textsuperscript{43} 7 CCH 1968 STAND. FED. TAX REP. §8067, at 73795 reports that: "a group of twelve Wisconsin doctors who formed a common law trust for the operation of a medical clinic have petitioned the Tax Court contesting the Internal Revenue Service's determination that they should be taxed as partners of income of the clinic. Also at issue is the IRS determination that the doctors are not entitled to the sick pay exclusion."

\textsuperscript{44} The cases which have used the state label rationale are the Empey, Wallace, and Holder cases. See supra note 9.
porated" organizations and is automatically classified as a corporation for federal tax purposes; and (2) The unreasonable discrimination rationale: these cases hold that the professional services regulations are to be given no special weight for their expertise and are invalid because they single out professional corporations and unreasonably discriminated against them.

A. The State Label Rationale

The state label rationale was applied in Empey v. United States which was the first case to invalidate the professional services regulations. The case involved a refund suit brought in the District Court of Colorado by a member of a four member law firm which had incorporated under the Colorado provision. The District Court determined that the professional services regulations "are inconsistent with the statute and the judicial construction thereof." The court examined the Internal Revenue Code definition of a "partnership" and concluded that it applies only to "unincorporated" organizations. Since Colorado had incorporated the law firm the court decided that it could not be classified as a partnership. To supplement its rationale the court pointed out that there have been no cases in which an incorporated organization has been construed as a partnership, and it went on to cite the Pelton, Kintner, and Galt cases as authority that such organizations of professional men ought to be taxed as corporations. On appeal to the Tenth Circuit, the Empey case was affirmed in

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45 The cases which have used the unreasonable discrimination rationale are: O'Neill, Kurnser, and Holder. See note 9.


50 The Court stated: "The defendant has cited no cases and we have found none which has construed the term "partnership" to include an "incorporated" organization, nor has the defendant referred to any legislative history which would indicate a Congressional intent to do so." Empey v United States, 272 F Supp 851, 853 (D Colo 1967), aff'd P-H §69-328 (10th Cir 1969).

51 Id. The Court went even further and without a detailed analysis concluded that even if the professional services regulations were valid, the corporation involved in the Empey case would have qualified as a corporation within the regulation's requirements. This part of the decision has been criticized in a recent law review comment at 29 Montana L Rev 229 (1968).

an opinion which relied on the same state label definitional rationale. The Tenth Circuit stated that the professional services regulations did violence to long followed administrative practice and to the cases and that the Treasury Department was attempting to legislate in an area which ought to be left to Congressional action.\footnote{The Court stated: "To treat as a partnership for federal income tax purposes a corporation, organized and chartered under state laws as a corporation and operated as such in good faith, does violence to the statutory definitions of the terms "partnership" and "corporation," to long followed administrative practice prior to 1965, and to the decided cases dealing with analogous organizations. Moreover, Congress has not seen fit to take any legislative action to overturn such long standing practices and decisions, and the Treasury Department only undertook to do so by a greatly belated Regulation." Empey v. United States, P-H \$69-328, 69-436 (10th Cir. 1969).}

Another case which applied the state label rationale was \textit{Wallace v. United States}\footnote{68-2 U.S. Tax Cas. \$9669 (E.D. Ark.). The \textit{Wallace} court did cite the cases which based their decisions on the unreasonable discrimination rationale (see note 45) but it based its conclusion on the \textit{Empey} \$7701(a)(2) definitional basis.} which involved an action by a group of incorporated Arkansas doctors to qualify their corporate profit sharing plan. The \textit{Wallace} Court relied primarily upon the District Court opinion in \textit{Empey} to invalidate the professional services regulations on the same definitional rationale and to uphold the doctors' corporate classification for federal tax purposes.

In effect what the \textit{Empey} and \textit{Wallace} cases are stating is that once a state labels an organization as a corporation in these instances, Internal Revenue Code §§7701(a)(2) and 7701(a)(3) automatically require it to be so classified. This conclusion may be supported by arguments that no case has ever held that a state labeled corporation should be given non-corporate status for federal income tax purposes,\footnote{Bittker points out this fact in an excellent law review article on the subject. Bittker, \textit{Professional Associations and Federal Income Taxation: Some Questions and Comments}, 17 \textit{Tax L. Rev.} 1, 26 (1961). The \textit{Empey} Court also pointed out this fact. See text accompanying note 50.} that no state would grant corporate status to an organization without conferring corporate resemblance characteristics upon it,\footnote{This argument is made in a recent law review article. Eaton \textit{Professional Associations as Planning Techniques N.Y.U. 24th Inst. on Fed. Tax} 671, 673 (1966). A question also arises as to whether the case of Commissioner v. Bosch, 387 U.S. 456 (1967), requires that the state label rationale be binding on federal tax consequences. The \textit{Bosch} case held that a determination of a state's law by the state's highest court binds a federal court applying the federal tax statute requiring determination of state law. However, since the state label rationale of \textit{Empey} is concerned with a federal definitional statute it is a federal tax term and state law should not control. State law would be important, however, to determine whether the various types of corporate resemblance characteristics are present. For a more detailed discussion of these conclusions with respect to the \textit{Bosch} case, see Comment, \textit{Taxation of Professional Corporations}, 37 \textit{CEN. L. Rev.} 328, 336 (1968).} and that a state labeled corporation
could be later disregarded as a sham or a dummy.\footnote{See Comment, \textit{Professional Corporations and Associations}, 75 \textit{Harv. L. Rev.} 776, 785 (1962).}

A strong argument may be made against the state label rationale on the grounds that any organization which a state labels as a corporation should not automatically qualify that organization as a corporation under §7701 (a)(3). In an article on this subject Bittker stated that “the Code uses the term ‘corporation’ as a brief summary of a group of legal consequences attached by state law to a business organization,” but that it does not “embrace all organizations to which a state chooses to apply the label ‘corporation.’”\footnote{Bittker, \textit{Professional Associations and Federal Income Taxation: Some Questions and Comments}, 17 \textit{Tax L. Rev.} 1, 26 (1961).} It is further argued that although the \textit{Morrissey} corporate resemblance test has only been applied in a situation in which a noncorporate entity was treated as a corporation, nevertheless, the same characteristics ought to be used to determine whether a state labeled corporate entity in substance is a noncorporate entity.\footnote{See text accompanying note 30. See supra note 26 for quote from the \textit{Galt} case in which the court held that a state label on an organization should neither provide nor deny its corporate status for federal tax purposes.}

\textbf{B. The Unreasonable Discrimination Rationale}

A second line of reasoning which has been used to invalidate the professional services regulations is the unreasonable discrimination rationale. The first case to use this alternative rationale was \textit{O’Neill v. United States}\footnote{281 F.Supp. 359 (N.D. Ohio 1968).} which involved a refund suit in the Ohio District Court by a member of a group of Ohio radiologists claiming federal corporate tax status. The radiologists had formed a business organization which qualified as a professional organization under Ohio law.\footnote{\textit{Ohio Rev. Code} §1785.01 \textit{et. seq.}} Corporate law of Ohio applied to such an association, except that professional employees remained absolutely liable for their own acts. Rather than relying upon the §7701(a)(2) state label rationale, the court in \textit{O’Neill} concluded that the promulgation of the professional services regulations was “an instance of administrative overreaching.”\footnote{\textit{O’Neill v. United States}, 281 F.Supp. 359, 364 (N.D. Ohio 1968).} The court first examined the Treasury’s power to issue interpretative regulations and recognized the fact that they are “often accorded special weight in the courts as an expert interpretation of the Government’s position.”\footnote{Id. at 363.} The court then cited a law review article\footnote{Mitchell Rogovin, \textit{The Four R’s Regulation, Ruling, Reliance, and Retroactivity}, 43 \textit{Taxes} 156 (1965).} which
stated that the amount of special weight which was to be given to the regulations was dependent on the strength of three factors: "(1) legislative re-enactment; (2) a long-standing administrative practice or interpretation; and (3) contemporaneous construction by an agency of a statutory term." The court examined each of the factors and decided that none of them existed with respect to the professional services regulations and consequently no special weight should be given for expertise in the regulations. The court was then allowed to use its independent judgment to determine the validity of the regulations. It pointed out that the regulations established more stringent standards for professional service organizations than for all other kinds of organizations and it concluded that:

The discrimination perpetuated in the regulation is not supported by the statute, judicial precedent, or sound tax policy. In short, the regulation is an instance of administrative overreaching.\textsuperscript{66}

After the court invalidated the regulations it then went on to find that the Ohio association qualified as a corporation for tax consequences by applying the \textit{Kintner} regulations.\textsuperscript{67}

The unreasonable discrimination rationale was also used in the case of \textit{Kurzner v. United States}\textsuperscript{68} by the Florida District Court to invalidate the professional services regulations. The \textit{Kurzner} case involved a two doctor corporation formed under the Florida Professional Service Corporation Act.\textsuperscript{69} The court concluded that the dual set of criteria which imposed more stringent requirements on professional corporations than on other types of service organizations was "unreasonable."\textsuperscript{70} The \textit{Kurzner} court paid lip service to the state label rationale for invalidating the regulations but expressly added that it was not basing its decision upon that rationale.\textsuperscript{71} The court then varied its result from the \textit{O'Neill} case by concluding that the corporation should have federal corporate tax status on the basis of the judicial factors of the \textit{Morrissey} case rather than on the

\textsuperscript{67} \textit{Id.} at 363.
\textsuperscript{68} The Court used \textit{Treas. Reg. §301.7701-2 (a)-(f)} and consequently only excluded the specific provisions of the professional services regulations. The taxpayer had also attempted to use an alternative state label argument but the court stated that in view of the above finding, it did not have to reach the state label issue. \textit{Id.} at 364–365.
\textsuperscript{69} 286 F.Supp. 839 (S.D. Fla. 1968).
\textsuperscript{70} Fla. Stat., ch. 621.
\textsuperscript{71} \textit{Kurzner} v. United States, 286 F.Supp. 839, 843 (S.D. Fla. 1968).
\textsuperscript{71} \textit{Id.} at 844.
basis of the *Kintner* regulations which were used in *O'Neill*.\textsuperscript{72}

A fifth case invalidating the professional services regulations is *Holder v. United States*\textsuperscript{73} involving a refund suit by a group of doctors who had formed a Professional Association under a Georgia statute.\textsuperscript{74} The court invalidated the regulations on the basis of both of the above discussed rationales, although it stated that the case was "identical" to *O'Neill* whose reasoning was "sound."\textsuperscript{75} The court then upheld the corporate tax status of the Georgia association under both the *Morrissey* case and the *Kintner* regulations.

With the promulgation of the professional services regulations the government attempted to accomplish by regulation what it had failed to accomplish in pre-1965 litigation. Although it appears from the current litigation that this attempt at administrative overreaching will and ought to fail, nevertheless, there is still the question of which is the better of the two above rationales. The state label rationale has the advantage of simplicity in that if it is followed then any professional corporation will automatically have federal corporate tax consequences. This would include a sole practitioner as well as groups of professional men. A decision to invalidate the regulations under the unreasonable discrimination rationale is more complicated because the courts are still left with the determination of whether a particular organization should be granted corporate status for federal tax purposes. There are three alternative tests which could be used in making that determination: (1) use of the 1960 *Kintner* regulations;\textsuperscript{76} (2) use of the *Morrissey* factors without the specific *Kintner* definitions;\textsuperscript{77} (3) use of §7701(a)(3) to automatically classify such groups as corpora-

\textsuperscript{72} The difference between the two is essentially that the various characteristics are not as well defined under *Morrissey* and that the *Kintner* regulations take a pro-partnership status position. See text accompanying footnotes 16 and 28.


\textsuperscript{76} The courts in *O'Neill* and *Holder* used the *Kintner* regulations (other than §301.7701-2 [h]) to determine the organization's federal tax status after invalidating §301.7701-2(h).

\textsuperscript{77} The courts in *Kursner* and *Holder* looked to the *Morrissey* factors rather than the *Kintner* regulations. This result could be reached either because the courts would limit the *Kintner* regulations only to unincorporated groups (see text accompanying note 30) or because the courts question the validity of the 1960 regulations as well as the 1965 regulations. The court in *Kursner* did not indicate why it had used the *Morrissey* factors and the court in *Holder* used both the *Morrissey* factors and the *Kintner* regulations. (See text accompanying note 76).
tions by limiting the *Morrissey* factors and the *Kintner* regulations to only unincorporated groups.\(^78\)

It is quite possible that the question of the validity of the professional services regulations will reach the Supreme Court.\(^79\) It is the writer's opinion that the Supreme Court ought to invalidate the regulations and that the unreasonable discrimination rationale would be the preferable basis upon which to arrive at that conclusion.\(^80\) It is hoped that if the Supreme Court reaches that decision it will also take the opportunity to clarify and further elaborate on the *Morrissey* factors.\(^81\) The remainder of the article will consider the chances for a professional services corporation under the California Act to be classified as a corporation for federal tax purposes under the various alternative determinations that the courts may reach.

## III

**FEDERAL TAX STATUS OF CORPORATIONS UNDER THE MOSCON**

California's professional men are faced with the question of whether to immediately incorporate or whether to shy away from incorporation under the Commissioner's scare techniques until a final determination of the validity of the professional service regulations is made. When that final determination is made, there are five alternative conclusions which the courts could reach:

1. The courts could use the *Empsey* state label rationale to invalidate the professional services regulations and grant federal corporate tax status to the professional corporations.\(^82\)
2. The courts could invalidate the professional services regulations as an unreasonable discrimination and then determine the federal tax status by state label.\(^83\)
3. The courts could set aside the regulations as an unfair discrimination and then determine federal tax status by the *Morrissey* factors.\(^84\)

\(^78\) This result would be reached by stating that *Morrissey* is limited to non-corporate type cases and by limiting the *Kintner* regulations to only unincorporated groups. The result would then be identical to the one reached under the state label rationale.

\(^79\) Since the commissioner has appealed several cases, it appears that he will take the case to the Supreme Court, unless he is not victorious in any of his circuit court appeals.

\(^80\) The conclusion is based upon the reasoning used in the text accompanying note 58.

\(^81\) The Supreme Court has never commented on the 1960 *Kintner* regulations and its only statements concerning this area were the rather vague statements in the *Morrissey* case. (See text accompanying note 17).

\(^82\) See text accompanying note 44 and 46–59.

\(^83\) See text accompanying note 60–72 and see note 78.

\(^84\) See text accompanying note 60–72 and see note 77.
(4) The courts could set aside the regulations as an unfair discrimination and then turn to the Kintner regulations. 85  
(5) The courts could uphold the validity of the professional service regulations.  

Due to the fact that it may be several years before a final determination is reached, California professional men who are considering immediately incorporating ought to consider whether they would be granted federal corporate status under each of the above alternatives. The remainder of this article will consider the federal tax consequences to California professional men under the above alternatives. It will first consider the consequences to groups of two or more professional men who use the California Act to incorporate and it will then consider the consequences to sole practitioners who incorporate.

A. Consequences to Groups of Professional Men

(1) The State Label Solutions  

If the courts used either the state label rationale of the Empney case or they instead used the unfair discrimination rationale of Kurzner and O'Neill to invalidate the regulations and then deferred to state labels because of the inapplicability of both the Morrissey case and the Kintner regulations, 86 then a California professional services corporation made up of a group of individuals would have corporate status for federal tax purposes. Even though a corporation is granted federal corporate status, it is still possible that a court could invalidate the corporation as a sham or dummy or for "lack of a business purpose." 87 This possibility would be remote except in an extreme case.

(2) The Morrissey Characteristics  

If the courts determined to set aside the regulations on the basis of an unfair discrimination, then the courts could well turn to the Supreme

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85 See text accompanying note 60–72 and see note 76.  
86 See note 78.  
87 The "business purpose" doctrine was developed in the case of Gregory v. Helvering, 293 U.S. 465 (1935), but would not appear to apply in these cases as adequate business purposes could easily be found. The adequate business purpose of "controlling a sizeable and unwieldy corporation" was found in the O'Neill case, 281 F.Supp. 359, 361 (N.D. Ohio 1968). Another adequate business purpose would seem to be to limit the personal liability of the members of a firm. See note 126 pointing out that the doctrine poses a much greater threat to the sole practitioner. For a discussion of some of these dangers as well as other possible dangers see Bittker, Professional Associations and Federal Income Taxation: Some Question and Comments, 17 Tax L. Rev. 1, 5 n. 8 (1961).
Court's decision in *Morrissey* to determine the federal tax status of a California professional services corporation. Recall that the *Morrissey* case used a test of corporate resemblance as opposed to corporate identity and set forth four characteristics to determine whether there was such resemblance concluding that the *Morrissey* trust resembled a corporation and was therefore an "association." 88 The Court was vague in its definition of the four characteristics thereby implying that only a similarity or resemblance to those characteristics is required as opposed to very strict or identical characteristics.

The *Morrissey* Court first stated that since the trust was secure from termination by the death of the beneficiaries, it had continuity of life similar to a corporation 89 and was distinguishable from a partnership which would automatically legally terminate upon the death of a partner. Although a California professional services corporation might possibly terminate on the death or disqualification from practice of a shareholder, it would not automatically or legally be required to do so 90 and consequently it would have the characteristic of continuity of life.

Secondly, in *Morrissey* the nature of the trustee's functions provided the trust with the characteristic of centralization of management. 91 In a trust relationship the beneficiaries also have some powers over the trustees which is similar to a shareholder-director centralization of management in a corporation. Since there would be a similar division of powers in a Cali-

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88 The Court based its decision both on the trust's corporate characteristics and the fact that the trust was actively engaged in carrying on a business. The Court used the corporate resemblance test to conclude that the trust was an "association" and therefore taxable as a corporation. (See text accompanying note 16). Since a group of professional men are actively engaged in a trade or business, the question becomes whether they should be classified as a partnership or a corporation and the four corporate characteristics become relevant in making that determination.

90 California Corporations Code §§13407 and 13408 provide that failure of the professional corporation or of a qualified licensed professional to reacquire the shares of stock of a disqualified shareholder within 90 days after disqualification or a deceased shareholder within six months after death are grounds for the agency regulating the profession in which the corporation is engaged to suspend or revoke the certificate of registration. Such a suspension or revocation will disqualify the corporation from rendering professional services. A recent article has concluded that "loss of the certificate of registration would preclude corporate practice of the profession, . . . but . . . would not dissolve the corporation or preclude it from continuing to engage in any other lawful business." *Peterson et al., Professional Corporations*, 43 Cal. State Bar J. 884, 890 (1968). Therefore while the death or disqualification of a shareholder could possibly cause the termination of a corporation or the termination of its power to render professional services, nevertheless it would not automatically terminate or not legally be required to terminate in all events as a partnership would.
fornia professional corporation, the quality of centralization of management would be present.

A further characteristic in *Morrissey* was limited liability which the Court defined as "the limitation of the personal liability of participants to the property embarked in the undertaking." The California Act provides for a form of limited liability in which through the use of insurance or otherwise any shareholder of the professional corporation is not liable beyond the property of the corporation except for liability arising from his own acts as an employee. This is a form of limited liability which is not identical to the *Morrissey* case because it is broader due to the shareholder-employee relationship, but it is not as broad as the liability under a partnership.

Finally, the Court stated that the organization could have "the transfer of beneficial interests without affecting the continuity of the enterprise." This characteristic of transferability of interest is present with some distinctions in a California professional corporation.

In summary there are characteristics present in a California professional service corporation which closely resemble those set forth by the Supreme Court in the *Morrissey* case. Consequently if the courts choose to use the alternative of applying the *Morrissey* characteristics then a group incorporated under the California Act will qualify as a corporation for federal tax purposes.

(3) The Kintner Regulations

A fourth alternative would be for the courts to set aside the professional services regulations as an unfair discrimination and then use the remaining Kintner regulations to determine the group's federal tax status. The same four characteristics are used to determine an entity's tax status

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92 California Corporations Code §13403 provides that the provisions of the General Corporation Law shall apply to professional corporations, and it provides for a director or directors of the corporation, thereby giving the corporation centralization of management.


94 Professional corporations have limited liability, subject to showing evidence of security by insurance "or otherwise" from claims of its clients for errors and omissions arising out of the rendering of services. CAL. BUS. & PROF. CODE §1808 (dentists), §2508 (doctors) and §6171 (lawyers) (1968).


96 California professional corporations provide for a transfer of one's interest without a termination of the entity, but there are restrictions upon the persons to whom the stock may be transferred. California Corporation Code §13407 limits the transferability of stock in a professional corporation to the corporation itself or to only licensed persons. Other transfers of the stock are void.

97 This would include Treas. Reg. §301.7701-2 (a)-(f).
under the Kintner regulations that were used in Morrissey except that the Kintner regulations attempt to be more definitive and also hedge toward partnership status. The regulations provide that an organization will not be classified as a corporation "unless such organization has more corporate characteristics than noncorporate characteristics."

The first characteristic to be considered is continuity of life. The Kintner regulations provide:

An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause the dissolution of the organization. On the other hand, if the death, . . . retirement, . . . or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.

Although death, expulsion, etc., of a shareholder could in very limited circumstances cause the dissolution of a California professional corporation, this would rarely be the case. These events would not immediately nor automatically cause the dissolution of the organization as it would in the case of a partnership. It might be argued that no continuity exists due to the state's power to revoke the certificate of registration or due to the fact that death of a shareholder could possibly imperil the corporate life. The better conclusion would seem to be that these professional corporations . . . do have substantial continuity upon the events which normally cause automatic dissolution of a partnership, since any dissolution which can occur is not likely, nor automatic, nor immediate.

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98 See supra note 29.
99 Treas. Reg. §301.7701-2(a)(3) (1960). Treas. Reg. §301.7701-2(a)(1) similarly provides: "An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust."
100 Treas. Reg. §301.7701-2(b)(1) (1960). The result here may well turn on the question of whether the word "will" means "could under any circumstances" or whether it means "must" or "would likely."
101 This very limited situation would be one in which: (1) there was a failure of the corporation or licensed person to reacquire the shares of a decedent or disqualified person within the allowed time (CAL. CORP. CODE §13407); (2) the agency determines to revoke the certificate of registration (CAL. CORP. CODE §13407); and (3) either the revocation dissolves the corporation or by "dissolution of the organization" the regulations mean dissolve its power to render professional services as opposed to a dissolution of the entity itself. (CAL. CORP. CODE §§13407 and 13408) (see supra note 90).
and that continuity of life or at least a modified continuity of life exists with respect to California professional corporations.

Centralization of management is the second factor to be taken into consideration. The regulations provide that:

An organization has centralized management if any person (or any groups of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation.\textsuperscript{104}

The California Act provides for directors of the corporation and that the general corporate laws shall be applicable to them.\textsuperscript{105} In a professional corporation in which there are fewer directors than shareholders,\textsuperscript{106} some degree of centralization of management would exist. The strength of this characteristic would be dependent upon the scope of the management function of the directors with more weight given to directors making important professional decisions as opposed to ones making mere administrative decisions.\textsuperscript{107}

The third characteristic to be considered is limited liability which the \textit{Kintner} regulations state is met if:

under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.\textsuperscript{108}

The California Act provides that in order to be given state corporate status a professional services group must show evidence of security by insurance or otherwise for claims of its clients for errors and omissions arising out of the rendering of services.\textsuperscript{109} Once corporate status is given the shareholders cannot be held personally liable except for their acts as employees, and consequently the characteristic of limited liability is present.

\textsuperscript{104} Treas. Reg. §301.7701-2(c)(1) (1960).

\textsuperscript{105} Cal. Corp. Code §13403.

\textsuperscript{106} The California Act does not, at least in the case of a small professional corporation, require fewer directors than shareholders. Cal. Corp. Code §13403.

\textsuperscript{107} Bitker, supra note 102 at 13–15; Scallen, supra note 103 at 683.

\textsuperscript{108} Treas. Reg. §301.7701-2(d) (1) (1960).

\textsuperscript{109} See supra note 94. Thus while a professional man could be personally liable for his own acts, he is not liable for the acts of the other professional men, regular employees, or the corporation itself.
The final characteristic is the free transferability of interests. The regulations provide that an organization has free transferability if:

each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. . . . [I]f each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interests to other members at its fair market value it will be recognized that a modified form of free transferability of interest exists.\textsuperscript{110}

The California Act requires that only persons licensed within a profession are permitted to be shareholders of a professional corporation although such shareholders are not required to render services to the corporation.\textsuperscript{111} It would then seem that although there is a limitation on the class of persons who may be shareholders, nevertheless local law allows free transferability as that term is used in the regulations absent any special provisions or arrangements within the corporation itself. If there were a special corporate arrangement giving the corporation a right of first refusal in the event of a sale then only a modified transferability would be present.\textsuperscript{112} However, if a special provision required the approval of other shareholders pursuant to any sale to an outside person, then there would be no free transferability under the \textit{Kintner} provisions.\textsuperscript{113} The question of whether free transferability exists under the California Act depends upon any special arrangements within the corporation itself.

In summary then the following results as to the characteristics would be reached by a California professional corporation under the \textit{Kintner} regulations:

\begin{itemize}
  \item \textit{(1) Continuity of life}: present.
  \item \textit{(2) Centralisation of management}: present (if there are fewer directors than shareholders) although not as strong as a regular corporation.
  \item \textit{(3) Limited Liability}: present.
  \item \textit{(4) Free transferability of interests}: may be present, present in a
\end{itemize}

\textsuperscript{110} Treas. Reg. §301.7701-2(e) (1) and (2) (1960).
\textsuperscript{111} Cal. Corp. Code §13406 only requires shareholders to be licensed persons but does not require them to actually be employees of the corporation.
\textsuperscript{112} Treas. Reg. §301.7701-2(g), Exam. 4, 5, and 6 (1960).
\textsuperscript{113} Treas. Reg. §301.7701-2(g), Exam. 3 (1960). Bittker points out that a similar type of argument could be used to argue that the practical aspects of transferability in the case of most small groups of professional men would be so likely to bring about a complete reshuffling of the organization that the transferability requirement discussed in the regulations would not be present in any professional organizations. Bittker, \textit{Professional Associations and Federal Income Taxation: Some Questions and Comments}, 17 Tax L. Rev. 1, 20 (1961).
modified form, or absent depending upon the particular arrangements within the corporation.

Since a corporation of a group of California professional men would likely have more corporate than noncorporate characteristics, it would likely have federal corporate tax status\(^{114}\) under the *Kintner* regulations.

(4) *The Professional Services Regulations*

The final alternative which the courts could reach would be to uphold the government's professional services regulations on the grounds that the interpretive regulations are valid exercise of administrative authority. These regulations are similar to the *Kintner* regulations in that federal tax classification is dependent upon a majority of the same four characteristics. The definitions of the characteristics are more detailed in the professional services regulations in an attempt to deny corporate status to such organizations.\(^{115}\)

The first characteristic to be again considered is continuity of life. The regulations make a strong effort to deny a professional corporation this characteristic. They state that continuity of life is not present:

> if the death, insanity, bankruptcy, retirement, resignation, expulsion, professional disqualification, or election to inconsistent public office will (determined without regard to any agreement among the members) cause under local law the dissolution of the organization.\(^{116}\)

They then state that continuity is not present if there is a requirement that to be a shareholder one must also be an employee. There is no such requirement under the California Act.\(^{117}\) Consequently, there would appear to be continuity under the California provisions except that one must question the meaning of the word "will" under the regulations. The pro-

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\(^{114}\) This conclusion is still subject to some question. While the *Kintner* regulations attempt to be definitive, they are still vague in some respects and the cases have not clarified them. (See, for example, note 100). If a very narrow, pro-partnership interpretation of the *Kintner* regulations were made, then it might be concluded that the California Act would not meet the *Kintner* requirements. This conclusion was made by Bittker in his article considering the federal tax status of a professional association under the Georgia Professional Association Act. Although the Bittker article involved an association he went on to extend his conclusions to corporations under acts such as the California provisions. Bittker, *supra* note 113 at 6–22 and 25–28. Bittker affirmed his conclusions in a second article Bittker, *Professional Service Organizations: A Critique of the Literature*, 23 Tax L. Rev. 429, 448–449 (1968). It is likely however that under the Scallen analysis of the *Kintner* regulations Scallen would agree that a California professional corporation would be classified as a corporation for federal tax purposes. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 Minn. L. Rev. 603 (1965).

\(^{115}\) See text accompanying notes 35–40.


\(^{117}\) See note 111.
posed regulations had included the words "will in fact," but the words "in fact" were omitted from the final regulations.\textsuperscript{118} Whether a California professional corporation has continuity of life is dependent upon the meaning of the word "will." If it means "must" or "will automatically or immediately" then the characteristic is present. If, however, it means "might possibly" or "could in some circumstances," then the characteristic of continuity would not be present.\textsuperscript{119}

The professional services regulations are very strict in their definition of centralization of management.\textsuperscript{120} The regulations conclude that as a matter of fact the characteristic of centralization of management cannot exist in a professional services organization. Therefore, since we have assumed that the courts have determined that the regulations are valid, it must be concluded that a California professional corporation does not have centralization of management.

The third characteristic of limited liability would appear to be present under the California Act. The regulations state that:

\textsuperscript{118} 28 Fed. Reg. §13750 (1963). The meaning of "will in fact" is subject to two interpretations. In his article Scallen interprets it to mean that one looks to what actually would occur as a practical matter and feels that its deletion is beneficial. (See supra note 103 at 697–698). However, "will in fact" might also be interpreted to mean "must" as opposed to "might possibly" if just the word "will" were used. If this is the case then the deletion is harmful.

\textsuperscript{119} While the author recognizes the fact that when dealing with the Kintner regulations the same language was used (Treas. Reg. §301.7701–2(h)(1) (1960)), nevertheless the professional services regulations might be distinguishable because these regulations are directed specifically at such professional groups and the specific section of the regulation is intended to deprive groups of continuity. It must also be pointed out that if the courts upheld the professional services regulations they would be doing so in an attitude of following the government's views in a situation in which the word "will" would be interpreted as broadly as possible. It is possible, therefore, that although the word "will" might have been interpreted to mean one thing in a Kintner regulations situation it would have a different meaning under the professional services regulations.

\textsuperscript{120} The regulations first state that the managers of a professional organization must have authority to make all of the following determinations: (1) the hiring and firing of professional members of the organization and its professional and lay employees, (2) the compensation of the members and of such employees, (3) the conditions of employment—such as working hours, vacation periods, and sick leave, (4) the persons who will be accepted as clients or patients, (5) who will handle each individual case or matter, (6) the professional policies and procedures to be followed in handling each case, (7) the fees to be charged by the organization, (8) the nature of the records to be kept, their use and their disposition, and (9) the times and amounts of distributions of earnings of the organization to its members as such. The regulations then state that "the managers of a professional service organization in which a member retains traditional professional responsibility cannot have the continuing exclusive authority to determine all of the matters described in the preceding sentence." Treas. Reg. §301.7701–2(h)(3) (1965).
A professional service organization has the corporate characteristic of limited liability within the meaning of paragraph (d) of this section only if the personal liability of its members, in their capacity as members of the organization, is no greater in any aspect than that of shareholder-employees of an ordinary business corporation.\textsuperscript{121}

It has already been pointed out that in order to obtain corporate status in California the organization must have adequate security for claims arising out of its rendering of services.\textsuperscript{122} If corporate status is obtained under state law then the requirement of the regulations is met because the liability is no greater than that of shareholder-employees of an ordinary business corporation and consequently the organization has the characteristic of limited liability.

The final characteristic to be considered under the professional services regulations is free transferability of interests. The conclusion reached under these regulations is the same as the one reached under the Kintner regulations that free transferability may exist under the California Act but whether it exists will be dependent upon the types of special arrangements or agreements within the firm itself. The regulations in this area are more specific than were the Kintner regulations,\textsuperscript{123} but the conclusions would be the same.\textsuperscript{124}

In summary, the following results as to the characteristics would be reached in the case of a California professional corporation under the professional services regulations:

(1) \textit{Continuity of life}: may be present although the word "will" makes its presence unlikely.

(2) \textit{Centralization of management}: not present.

(3) \textit{Limited liability}: present.

(4) \textit{Free transferability of interests}: may be present, present in a modified form, or absent depending upon the particular arrangements within the corporation.

The outcome of a California professional corporation under the regulations is extremely hazy. If the word "will" were interpreted as "must" or "will automatically" and if transferability of the shares were not subject to restrictive arrangements other than a corporate right of first refusal, then a

\textsuperscript{121} Treas. Reg. §301.7701–2(h)(4) (1965).
\textsuperscript{122} See text accompanying notes 94 and 109.
\textsuperscript{123} The regulations provide that if a corporate right of first refusal is present then free transferability exists in a modified form. However, if that right of first refusal is coupled with an arrangement under which the right to be a shareholder is contingent upon being an employee, then there is no free transferability. Treas. Reg. §301.7701–2(h)(5)(ii) (1965).
\textsuperscript{124} See text accompanying notes 111–113.
corporation under the California Act would have federal corporate tax status. If only one or neither of the two above factors were present then the organization would have federal partnership status.

B. Consequences to the Sole Practitioner

The question of classifying an incorporated sole practitioner for federal tax purposes raises some special problems not present in the case of groups of incorporated professionals. An examination of each of the alternatives ought to be made with regard to the sole practitioner.

If the courts were to adopt either of the two alternatives under which they relied upon state labels, then a sole practitioner would be given federal corporate tax status.\textsuperscript{126} However, the fact that a sole practitioner had been so classified does not mean that the corporate entity will automatically be upheld.

In the case of a sole practitioner under any of the alternatives which the courts might choose to use, the potential for the Commissioner to argue that the corporation is either "sham" or "dummy" or to apply the Gregory "business purpose" doctrine is strong.\textsuperscript{126} Although there are numerous cases which have upheld sole shareholder corporations nevertheless they are distinguishable because a business purpose can easily be found.\textsuperscript{127} The danger of the Commissioner applying one of these doctrines even after an organization has been classified as a corporation ought to be considered by a sole practitioner who is contemplating incorporation.

\textsuperscript{125} See text accompanying notes 82, 83 and 86.

\textsuperscript{126} Under the Professional Corporation law in California incorporation by a sole practitioner is a legal and valid form of doing business. Assuming a sole practitioner can show sufficient corporate characteristics to qualify for treatment as a corporation, he must still meet the "business purpose doctrine" to reap the Federal Tax benefits. By this doctrine the mere avoidance of taxation is held not to be a sufficient business purpose to qualify a separate entity for tax treatment as a corporation. However, the mere use of a form of business that also achieves a more beneficial tax treatment does not of necessity preclude the use of that form. If the corporation formed actually engages in business activity other than mere tax avoidance then in all likelihood a sufficient business purpose can be shown.

It is the holding of the so-called "business purpose" doctrine that a transaction will not be given effect for tax purposes unless it serves some purpose other than mere tax avoidance. The doctrine was developed in the case of Gregory v. Helvering, 293 U.S. 465 (1935), involving a spin-off in a corporate reorganization.

In the area of professional service corporations, the doctrine could be applied even though the corporation was classified as a corporation, so as to deprive the corporation of corporate tax status. This doctrine poses a much greater threat to a sole practitioner than to a group of professional men. Unless the sole practitioner can show some business purpose in incorporating other than tax avoidance he may well be denied the tax benefits of incorporation.

\textsuperscript{127} For example, most sole shareholder corporations have a definite purpose in incorporating of limiting the liability of the sole shareholder. In the case of a sole practitioner there is
Under any of the three other alternatives which the courts could reach, the federal tax status of an incorporated sole practitioner is doubtful. If the courts were to apply the Morrissey corporate resemblance test by looking at the specific corporate characteristics outlined in Morrissey it is doubtful that they would conclude that a corporation is present. The vague factors of centralized management, limited liability, and continuity of life would likely be lacking.\footnote{Recall that the Morrissey case gave very vague definitions to the characteristics which it listed and that it would appear that one would apply a resemblance test as to each characteristic. (See text accompanying note 88). Using this rationale even though there is a technical limited liability (in that the sole shareholder while liable for his own acts, is not liable for corporate debts, etc.) and a technical continuity of life (the corporation would not automatically terminate on his death), nevertheless as a practical matter his liability and the firm’s continuity more nearly resemble a partnership due to the fact that there is only a partial limitation of liability and on his death it is likely that the firm would terminate or at least be “interrupted.” Morrissey v. Commissioner, 296 U.S. 344, 359 (1935).

128 If the courts were to use this test they would do so on the rationale that the facts of the Morrissey case involved a group of individuals in a trust situation and that the case of a one man trust or a sole shareholder case would be distinguishable so that one would not look to the particular characteristics of the Morrissey case but only a general corporate resemblance test.} The only characteristic which would be present is the free transferability of the shareholder’s interest. The courts in applying the Morrissey corporate resemblance test might instead merely require that an incorporated sole practitioner’s corporation merely resemble other sole shareholder corporations.\footnote{Treas. Reg. §301.7701-2(a) (2) (1960).} In that event a sole practitioner of a professional corporation would likely qualify for federal corporate tax status.

It is unlikely that the courts would turn to the Kintner regulations alternative due to the fact that the regulations themselves do not appear to apply to “a so-called one-man corporation and the sole proprietorship.”\footnote{The court nevertheless might still look at the same definitions of characteristics taking the point of view that the definitions themselves apply to incorporated as well as unincorporated groups.} If the courts did, however, use the Kintner regulations’ definitions of the characteristics,\footnote{The California Act requires only one director in a sole shareholder professional corporation. Cal. Corp. Code §13403.} there would be free transferability of interests, but no centralization of management.\footnote{The California Act requires only one director in a sole shareholder professional corporation. Cal. Corp. Code §13403.} While both continuity of life and limited liability are technically present, nevertheless as a practical matter they
are not present and consequently the outcome to the sole shareholder under the Kintner regulations is uncertain and depends upon whether the courts use a technical or practical analysis of the regulations.

Although the professional services regulations are specifically applicable to the sole shareholder situation, nevertheless the outcome to the sole shareholder is equally doubtful. Again while it could technically be argued that all the characteristics except centralization of management are present under the California Act, nevertheless the practical aspects of the corporation raise grave doubts as to the presence of continuity of life and limited liability.

In conclusion, the determination of whether a sole practitioner will acquire federal corporate tax status is extremely uncertain. While eventually it may be determined that a sole practitioner will have corporate tax status, nevertheless at the present time both the uncertainty under the five judicial alternatives and the lurking danger of the application of the "business purpose" doctrine make it impossible to advise the sole practitioner with any degree of certainty that by incorporating under the California Act he will be granted federal corporate tax status.

IV

CONCLUSION

The decision faced by California professional men whether to incorporate is extremely complex. The additional problem of whether that act of incorporation will permit the organization to be recognized as a corporation for federal tax purposes further complicates the decision. Until recently, the only solutions to the problem were found in a biased interpretative government regulation and a few court cases dealing with the general problem of federal tax classification. The Supreme Court has spoken in the area only once and in that opinion its analysis of the area was vague.

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133 See supra note 128. While these two characteristics might be present, both must be present to find corporate classification. Treas. Reg. §301.7701-2(a)(3) (1960).
136 While technically the corporate entity meets the essential requirements, nevertheless the practical aspects of the shareholder-employee relationship raise doubts as to whether the characteristics are met. See supra note 128.
136 A word of warning should be given. Even though a professional corporation is granted federal tax status, the Commissioner can still have some tricks up his sleeve to use against unsuspecting shareholders. The article has already discussed the application of a sham theory or the Gregory business purpose doctrine. Other possibilities are listed in Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1, 5 n. 8 (1961).
The question is one of whether professional men who determine that it would be to their advantage to incorporate should go ahead and do so immediately in view of their doubtful federal tax classification. In the case of a sole practitioner the law is anything but clear and consequently one could not advise a sole practitioner with any certainty that upon incorporating he will be granted federal corporate tax status.

The possibility of a group of two or more professional men incorporated under the California Act being classified as a corporation for federal tax purposes is much better or even good. Perhaps the safest advice to give to such a group who desire to acquire federal corporate status would be to incorporate under state law but to continue to pay federal taxes as a partnership. Once the law is clarified and if it allows such groups to be treated as corporations, then they could file refund suits for years open under the statute of limitations.\footnote{Internal Revenue Code §6511a provides a limitations period either three years from the filing of the return or two years from the payment of the tax whichever expires the later. It is possible therefore, that such a clarification could come prior to the statute of limitations having run on any year subsequent to that incorporation.}

It is hoped that the Supreme Court will have an opportunity in the near future to clarify the law both as to professional organizations and as to federal corporate classification in general. If such a clarification does not come from the Supreme Court then the burden should pass to Congress to legislate in an area which demands clarification.