Land & Water Law Review

Volume 6 | Issue 2 Article 11

1971

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Recommended Citation

Rosen, Martin J. (1971) "Professional Corporations - Advantages and Disadvantages," *Land & Water Law Review*: Vol. 6 : Iss. 2 , pp. 661 - 700.

Available at: https://scholarship.law.uwyo.edu/land_water/vol6/iss2/11

LAND AND WATER
LAW REVIEW

VOLUME VI 1971 NUMBER 2

The Forty-First Session of the State Legislature of Wyoming enacted a provision permitting the incorpation of professional firms (See Senate Enrolled Act, No. 16). The posibilities associated with this new act should be of particular concern to most practicing attorneys within the State of Wyoming. As the title to the article suggests, Mr. Rosen has delineated the advantages and disadvantages to a firm contemplating professional corporation. His discussion includes an analysis of the relevant tax and corporation, statutory and decisional law regarding professional incorporation, and also a discussion of the practical problems surrounding incorporation. Mr. Rosen concludes by suggesting practical guidelines and forms which a firm may adopt if it so desires to incorporate.

PROFESSIONAL CORPORATIONS--ADVANTAGES AND DISADVANTAGES

*Martin J. Rosen**

INTRODUCTION

THE primary benefits to be realized of practicing law as a professional corporation are those which have traditionally benefited any business enterprise using the corporate form. These benefits include both tax and non-tax benefits. On the other hand, incorporation is normally not regarded as a tax saving device for the entity. It is regarded as a tax saving device for the shareholders and employees, who by virtue of their new status, are entitled to certain tax advantages which were not otherwise available to them as either proprietors or partners. In addition, the entity, can be "tax expensive" because profits, unless carefully monitored, will be subject to double taxation; once when received by the corporation and secondly as dividends received by the shareholder. If the income of the law firm is about equal only to the reasonable salaries required by the lawyers of the corporation, then in-

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corporation by itself will probably make little difference taxwise. Therefore, before and detailed analysis is made of the benefits of incorporation, a rough initial decision should be made on the basis of the specific lawyers' income requirements and the firm's income producing ability. If the lawyer has a standard or style of living that exhausts all of the net income that he is currently earning as either a single proprietor or a partner, we need go no further. This practitioner will save very little by incorporation. In taking advantage of incorporation's tax saving features, the lawyer's present after tax cashflow may also be reduced 10-30 percent. This is because the major dollar saving benefit which will be discussed here is the accumulation of untaxed income which is then compounded tax free in qualified corporate profit and pension plans, and the accumulation of dollars within a corporation at favorable corporate tax rates.

Without this shift of investment opportunities, probably the major purposes of incorporation will never be realized. On the other hand, it is my very strong view that in addition to the tax considerations, there is an even more compelling reason that virtually requires the practicing attorney today to incorporate. I refer here to limited liability—a subject which I expect to become increasingly important to the practicing attorney.

Ethical Considerations

As we know, Canon 34 of the American Bar Association Canons of Professional Ethics prohibits a lawyer from dividing legal fees with anyone except another attorney, based upon a division of service or responsibility.[1] Previously there has been some indication that the ABA ethics committee would prohibit lawyers in a professional corporation from having a profit sharing plan which includes non-lawyers and beneficiaries, as would be required in order for the plan to qualify for favorable income tax treatment. The ABA now has indicated that this position has been modified.

1. ABA CANONS OF PROFESSIONAL ETHICS NO. 34.

Disciplinary Rule 3-102 of the New ABA Code of Professional Responsibility, which became effective in January of this year, specifically provides that:

> A lawyer or law firm may include non-lawyer employees in a retirement plan, even though the plan is based in full or in part on a profit sharing arrangement.[2]

Since, however, lawyers in many states are governed by the canons of the state bar association rather than the ABA, I suggest that your state bar rules be consulted, although I do not believe that there will be any serious ethical problem.

Revenue Ruling Concession by IRS

Until quite recently most of the legal literature on the subject of professional corporations was absolutely saturated with the dogged, but ill-reasoned attacks by the Internal Revenue Service. The IRS previously fought every professional corporation as a tax gimmick that had to be battled every inch of the way. In mid-1969 this position was reconsidered and in Revenue Ruling 70-101, IRB 1970-9, 13[3] issued in March of this year, the IRS announced that it will generally recognize organizations of professional people formed and operated under state law as *bona fide* corporations for federal tax purposes. (Its shift was previously announced in August, 1969, in T.I.R. No. 1019, 8-8-69.)[4]

At the present time every state except New York, Iowa, and the District of Columbia has a professional corporation or association act. The caveat here, however, in this recent ruling is that the government reserves the right to reach different conclusions in any cases reflecting "special circumstances". We will allude to some of these circumstances later. It should also be noted that this ruling relates solely to the issue of tax classification and nothing more. Professional corporations and attorneys are still subject to audits, taxes and disallowances based on considerations other than classification. In addition, for those of you from the States

2. ABA CODE OF PROFESSIONAL RESPONSIBILITY NO. 3-102.
3. REV. RUL. 70-101, 1970 INT. REV. BULL.
4. T.I.R. 1019 (1970).

of Illinois, Pennsylvania and Texas, the ruling indicates that the *date* of your corporation may prove determinative of its status since the IRS takes the position that only the latest state statutes are acquiesced in. Practitioners from those states should study the Revenue Ruling especially carefully.

Professional Corporation Case Law To Date

In light of the aforementioned Revenue Ruling, the tortuous legal history of the celebrated professional corporation cases from *Pelton v. Commissioner,*[5] to *U.S. v. Empey,*[6] are instructive for a variety of reasons but will not be labored here. Attachment One to this paper is an excellent analysis of recent cases prepared by Mr. Kline D. Strong of the Salt Lake City firm of Strong, Poelman & Fox which appeared in the February issue of *The Journal of Taxation.*[7]

BENEFITS AND ADVANTAGES OF INCORPORATING

Non-Tax Considerations

Limited Liability

Presently, as either sole proprietors or general partners in your law firm, you are fully liable for all of the tortious and contactual liabilities resulting from your conduct and also that of your partners, professional associates, and employees during the course of their employment. As recent cases show, this exposure can be quite broad indeed. In my view, the years ahead will see this exposure become an increasing area of litigation and liability to the detriment of both the profession and the practitioner. While this may be crystal ball gazing, I see over the horizon wider and deeper professional liability being imposed upon the practitioner, just as we have seen it in the fields of medical and accounting malpractice. Two recent California cases indicate my concern. In *Zemelman v. Boston Insurance,*[8] the California District Court of Appeals held that in partnership dealings with innocent third parties, all of the partners are responsible for the fraud of one

5. 82 F.2d 473 (7th Cir. 1936).
6. 406 F.2d 157 (10th Cir. 1969).
7. 32 J. TAXATION, Feb. 10, 1970, at 96.
8. 4 Cal. App. 3d 15, 84 Cal. Rptr. 206 (1970).

of the others, whether or not they are aware of the fraud or benefited from it. This had to do with a fraudulent claim of proceeds under a fire insurance policy.

In a case closer to our practice, the California Supreme Court has recntly held in the case of *Blackmon v. Hale,*[9] that a former law partner's theft from a firm trust account was actionable against the innocent law partners. The innocent partners could be held liable, the Court held on remand, as voluntary co-trustees of the plaintiff's (client's) money. The Court held that while trustees are not strictly liable for the wrongful acts of a co-trustee, they must exercise reasonable supervision over the latter's conduct and may render themselves liable by *negligent inattention* to their duties.

Therefore, I conclude the availability of a limited personal liability is an important consideration in a decision whether or not to incorporate. In California, for example, provided lawyers carry appropriate malpractice insurance coverage, there is no personal liability for the conduct of the other professional or non-professional employees performing services for the corporation. Of course, the individual committing a wrongful act is personally liable under any circumstances as is the corporation itself. However, the innocent practitioner has no personal liability over and beyond his investment in the corporation. My conclusion is that this consideration alone justifies the cost and bother of doing business in the corporate form.

Streamlined Business Administration

Clear advantages in business administration result from the continuity of the existence of the corporation and its centralized management compared with the typical law partnership. For most group law practices, especially the larger ones, the corporation offers obvious advantages in administration over the partnership form. This is probably especially true in firms which tend to have frequent admissions or withdrawals of lawyers; or where the senior men seem to be looking to other pursuits such as semi-retirement, accepting

9. 1 Cal. App. 3d 548, 83 Cal. Rptr. 194 (1970).

judgeships, political activity or becoming ranchers or farmers, as the case may be. In a partnership, for example, as you know the admission or withdrawal of a partner may technically terminate the partnersip with resulting tax, accounting and appraisal problems of assets and a valuation of liabilities. Where there are tangible assets and accounts receivable problems, these can be even more costly. In a corporation, however, since each attorney is an employee and should have an employment agreement as well as a buy-sell agreement with the corporation these problems are greatly simplified and the corporation continues as an entity unaffected by these changes.

In terms of day-to-day management, decision making, and leadership, a corporation operates under state statutes with abundant case law interpretations and with a formal organization to deal with the matters of control, authority and responsibility. These matters are far better defined and understood with a centralized management in which policy and decision making processes produce real benefits compared with partnerships where because of personal habits or tradition, authority is commonly either divided, spread too broadly, non-existent or resented, or all of these.

Employee Relations

A law firm, of course, is only as good as its people and this in turn is dependent upon the firm's ability to attract talented people and hold them. Successful recruitment of promising, well qualified employees is materially aided by the existence of a broad spectrum of retirement and insurance programs provided by the corporation. Maintenance of good employee morale is directly related quite often to these programs which can be readily understood and appreciated when properly communicated to the employees. This has to have a favorable effect upon the stability of the work team and the retention of key employees.

Although some people may argue that these benefits are just as readily available in proprietorships and partnerships, experience has shown me that they are seldom adopted on a meaningful scale, because of the inability of the lawyer partners to participate in these programs on a favorable tax basis.

Coverage Under Social Security, Workmen's Compensation and State Disability Statutes

As an employee, there is an advantage to the lawyer being covered under Social Security, Workmen's Compensation and State Disability Statutes. As an employee the corporation will, of course, pay a portion of the lawyer's Social Security taxes, just as it does for other employees. Coverage as an employee may accelerate benefits and increase them to the lawyer as an employee. Further, as an employee the lawyer will have all of the benefits under the Workmen's Compensation and State Disability Act paid for entirely by the corporation. At present, under state statutes, the lawyer may not be eligible to participate in these programs event at his own expense. These rights can have a very real value. For example, in California they have been calculated to amount to at least $150 per month, tax free. Since lawyers seem to die of heart failure as often as anyone else, there is abundant legal precedent for widows of lawyer employees to receive what amounts to "free" life insurance of approximately $20,000 under the Workmen's Compensation Act in such a state as California.

Business Other than the Practice of Law May Be Operated (Check State Statutes)

Depending on the state statutes involved, the professional corporation may engage in business activity other than the practice of law. For some lawyers with competent tax planning, this may be a very effective and advantageous way to conduct other businesses and at the same time provide a measure of tax shelter for the professional income. This may be done, for example, by acquiring real estate, oil and gas participation, or conducting favorably situated agricultural activities. This must be done very carefully, however, and be done in consideration of the remarks that will be made later concerning the penalty taxes on the corporation for the unreasonable accumulation of income in excess of $100,000.

Separation of Voting Control from Ownership of Shares

In a corporation, voting control can be separated from the ownership of stock. Voting trusts can be established. Proxies can be granted either revocably or irrevocably. Where a lawyer seeks to retire from the firm and sell his stock in it on an installment basis, he may do so and retain a measure of voting control in both his own and other stock until he is paid the full purchase price. A conditional proxy, for example, can be utilized as a security interest. In the event of default, he will automatically be returned controlling voting rights to protect his interests. Similarly, an older practitioner may, prior to affecting permanent changes in the firm, grant a revocable proxy to a younger shareholder to see how he does with the shareholder burdens and opportunities. If the power goes to the young man's head, then the older practitioner can simply revoke the proxy and return to the situation as before. In the same way, ownership of the stock can be separated from management of its corporate affairs. A professional person can continue to own stock in the corporation even while not participating in its management. As he gradually retires, he is not compelled to sell his stock, but may continue his participation for reasons of a personal nature, such as continuing his malpractice insurance (which can be quite important), and continuing to exercise to some degree the leverage upon his younger colleagues, rather than insisting on either being all the way in or all the way out of the firm.

Deferred Compensation Plans

In addition to the other benefits and separate from the retirement plans which we will be discussing in a moment, a corporation may enter into deferred compensation arrangements with selected employees on a discriminatory basis. Under such arrangements the corporation agrees to make continued payments to the employee in the nature of deferred compensation after the employee retires, or to his family after his death. This distribution may be made over a period of years and is commonly contingent upon the employee making himself available for consultation to the corporation and agreeing not to engage in competitive activities.

While a primary purpose of this arrangement is to save taxes by reducing taxable compensation during high income years, and taking payment after retirement when the former employee is generally in a much lower tax bracket, nonetheless this program offers other real benefits as well where it is desired to maintain the individual's tie to the firm after his full-time services are concluded.

As we will be seeing later, since the corporation on redemption of its shares of a senior shareholder suffers certain tax disadvantages compared to buy out of a partner, this may be one vehicle to balance the considerations when a senior shareholder wishes to retire. In effect, what is done is to redeem the shares at a relatively low cost since this is nondeductible to the corporation and sweeten the sale with a longer term deferred compensation arrangement which provides a deduction for the corporation (so long as reasonable), and which is taxed at ordinary income rates to the former practitioner. This then brings us to the subject of taxes and we will start with consideration of tax benefits to the practitioner and the professional corporation.

Tax Benefits and Advantages*

Comparison with the Keogh Act or H.R. 10 Plans: Really No Contest[10]

In the area of tax benefits, H.R. 10 or as it has come to be known H.R. 2½ really is a poor substitute for the advantages of professional incorporation, particularly in the area of discretionary income and retirement planning benefits. Briefly stated, the Keogh Act is an inadequate substitute for qualified corporate retirement plans for the following reasons:

*All citations are to the Internal Revenue Code of 1954, as amended.

10. Self-Employed Individuals Tax Retirement Act of 1962, Public Law 87-792, 76 Stat. 809 (1962).

(a) H.R. 10 has an annual deduction limitation of 10 percent of earned income or $2,500 as opposed to the much more liberal provisions of the corporate retirement plans for both pension and profit sharing (rule of thumb 25 percent of payroll of covered employees), or for either pension and profit sharing plans. (Pension plans have no percentage limitations as such.)[11]

(b) Any unused deductions to the partnership or individual for income tax purposes are lost to them in future years as opposed to the ability of the professional corporation to carry forward any excess contribution by it.[12]

(c) H.R. 10 has an immediate full vesting requirement for all regular employees as opposed to the more general requirements of "non-discrimination" vesting after a reasonable waiting period for employees of the corporation. This allows far greater latitude for the corporation, such as vesting 10-20 percent per year and redistribution of forfeitures by short-term employees.[13]

(d) H.R. 10 has a requirement that all employees with three years employment be covered by the plan as opposed to the general requirement of non-discrimination for a corporation.[14]

(e) H.R. 10 death benefits are taxable under the federal estate tax as opposed to the non-taxability of benefits available under a qualified corporate retirement plan, per § 2039(c).[15]

(f) H.R. 10 retirement funds may be invested only via four media: (i) into a bank trust; (ii) by purchase of selected contracts from an insurance company; (iii) into a special "custodial account" with a bank; and (iv) by purchase of special U.S. Government retirement bonds.[16]

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11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. INT. REV. CODE OF 1954 § 2039(c).
16. Self-Employed Individuals Tax Retirement Act of 1962, Public Law 87-792, 76 Stat. 809 (1962).

(g) The employee-lawyers may not act as trustees of the plan under H.R. 10, although they may under a corporate retirement plan.[17]

(h) Lawyers may not borrow from an H.R. 10 fund, while the professional corporation may do so from corporate retirement funds provided reasonable security and terms of repayment are provided, etc.[18]

(i) Even though employer contributions distributed upon retirement in a single year are no longer entitled to capital gain treatment as they were formerly, the corporate retirement plan may still allow more advantageous treatment under the income averaging rules than under H.R. 10 rules. Also, the appreciation in the corporate retirement fund is still taxable at capital gain rates. Not so under H.R. 10.[19]

(j) No benefits under an H.R. 10 plan retirement may be paid to a lawyer-principal until he is at least 59½ years of age and not later than the time he is 70½ years of age. No such arbitrary rules exist in the corporate retirement plan area. Corporate plan benefits may be paid at retirement, discharge, death, or resignation for any employee, or also for hardship. Note also that a corporate plan may cancel benefits to an employee of a corporation who is dishonest or competes with the corporation. Not so under H.R. 10. A question may be asked, what is the effect of incorporating and instituting a corporate retirement plan, when previously partners had set up an H.R. 10 retirement plan? There seems to be no definitive answer to this question yet. Knowledgeable persons have stated that so long as no benefits are paid to the partner or former partner until he reaches the age of 59½, or in a discriminatory fashion, none of the penalty provisions should obtain. Your best course is simply to keep the Keogh plan "frozen" until it is terminated for all persons in a non-discriminatory fashion; e.g. separation of former employees and/or at ages 59½ to 70½ for former proprietor/partners.[20]

17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*

Subchapter S Election

As I am sure most of you are aware, professional groups of ten or less shareholders can elect to operate as a Subchapter S corporation and thereby avoid being taxed as a corporation.[21] This offers some real advantages, not only in the avoidance of any possibility of a double taxation on dividends but also in the areas of personal holding company income, collapsible corporation, and unreasonable accumulation problems. I do not intend to do more than mention this possibility in passing because I am sure it is familiar to all of you, although most people have come to realize it is a very tricky election indeed. Not only is it affected ruthlessly by the admission of new shareholders and the death of a shareholder which may result in the inadvertent loss of the election, but also under the Tax Reform Act of 1969 serious adverse consequences now flow to corporations whose shareholders elect Subchapter S treatment. This is especially the case in the area of qualified profit sharing and pension plans where, in effect, the Subchapter S corporation is limited in its deductions to those which would otherwise be available to a partnership making a contribution to an H.R. 10 plan.[22] That is, $2,500 per employee or 10 percent of his earnings, whichever is less. Nonetheless, it is listed here because either the small law partnership or the single practitioner who incorporates his practice may have at least some of the benefits of incorporation—namely limited liability which I have stressed previously—and also not be taxed altogether unlike the manner in which he is taxed at the present time.

Tax Advantages to the Professional Employee are Substantial Profit-sharing, pension and thrift plans

The principal advantage in incorporating the practice is that corporate employees can benefit from the pension and profit sharing and thrift plans authorized in §§ 401-404 of the Code.[23] There is an immediate deduction by the corpora-

21. INT. REV. CODE OF 1954 § 1371(9)(l).
22. INT. REV. CODE OF 1954 § 1372.
23. INT. REV. CODE OF 1954 § 401-404.

tion for its contributions to a qualified plan. If the corporation earns more than $25,000 per year net, so that it is in the 48 percent bracket (ignoring the surcharge), then its contributions will cost only 52 cents on the dollar. On the other hand, corporate employees are not taxed until they receive distributions under §§ 402 and 403.[24] Generally, they will be either retired or semi-retired and in a much lower income tax bracket. Thus, even if taxed at the newly enacted income averaging rules, this treatment is decidedly favorable. The pension or profit sharing trust is itself exempt from tax under § 501(a).[25] All of its income is accumulated tax free, thus accumulating much more rapidly than can either an individual or an entity subject to income tax.

A single example demonstrates the dramatic effect of tax free accumulation. Assume that Lawyer Brown is presently earning $50,000 taxable income from his practice. He could justify an additional $7,500 of compensation based upon the billing and earnings of the professional corporation. If he simply earns an additional $7,500 per year taxable income in that bracket he will keep approximately 50 percent after taxes, or $3,750. Assuming he invests this $3,750 at 5 percent, he is going to be earning only 2½ percent net after taxes. Thus invested $3,750 for each of 25 years will result in the creation of a retirement fund of approximately $130,000 after taxes.

If, however, he were to incorporate this year, and his corporation set up a qualified profit sharing or pension plan and contributed the same $7,500 per year for his account to that plan, the following results would follow. The corporation income would remain unchanged since it gets a deduction for its contribution to the plan in the same manner as it would get the deduction as if it paid Lawyer Brown an additional salary sum of $7,500. Assuming that the plan would invest the same $7,500 at the same 5 percent rate, the plan, because it pays no income tax, would accumulate a fund at 5 percent per year instead of the 2½ percent rate for Lawyer Brown personally. At the end of 25 years, Lawyer Brown would accumulate in the qualified plan in excess of *$375,000 or almost triple the $130,000 that he would have under his own personal*

24. INT. REV. CODE OF 1954 § 402-403.
25. INT. REV. CODE OF 1954 § 501(a).

scheme. While the results under the Keogh plan would be somewhat improved, we have already discussed the fairly determinative reasons why the corporate plan offers a far more valuable retirement income and tax shelter vehicle.

Upon retirement, there are additional income tax advantages to the separated employee upon receipt of distribution from the plan. Capital gain rates may still apply to the appreciation in the fund over the corporation contribution, if a lump sum is distributed in a single year. Further, in computing the retirement income credit, a pension or annuity is not considered to be earned income under Internal Revenue Code § 37(c).[26] Distributions received by the employee after the age of 65 may benefit from the double exemption provided by § 151(c).[27] The distributions are taxed only as received under § 402(a).[28] There is a complete estate tax exemption on survivor benefits to the widow or children if death occurs while the professional man is still gainfully employed and the plan is qualified under § 2039(c).[29] There is no gift tax on the election of survivor benefits made by the employees under § 2517.[30]

For the professional corporation, the following maximum amounts may be currently deductible by it:

(1) Up to 15 percent of anual compensation of covered employees for a profit sharing plan;

(2) Up to 25-30 percent of compensation for a combination of qualified profit sharing and pension plans.

(3) All contributions regardless of percentage made to a qualified pension plan (subject to certain actuarial limits) so long as the plan is non-discriminatory.

A qualified thrift plan simply enables a participant to make a voluntary contribution to the plan, (usually not over 10 percent of the total compensation of the participant), which can accumulate tax free. The voluntary contribution by the employee is returned to the employee tax free and the

26. INT. REV. CODE OF 1954 § 37(c).
27. INT. REV. CODE OF 1954 § 151(c).
28. INT. REV. CODE OF 1954 § 402 (g).
29. INT. REV. CODE OF 1954 § 2039(c).
30. INT. REV. CODE OF 1954 § 2517.

gain thereon is taxed at capital gain rates on distribution, if received in a lump sum.

Insurance

The following insurance benefits can be provided to the professional with the premium deductible by the corporation and yet not taxable to the lawyer:

(i) Under §§ 79 and 162(a)(1),[31] group term life insurance with a principal sum of $50,000. Also premiums on group life coverage for wife and children up to $2,000 each are excludable from employee's income. There is a hidden, further advantage here. If the lawyer requires insurance over $50,000, he gets a further break since he is taxed not on his share of the employer's actual premium cost, but on a Treasury table of insurance costs. These can provide some real "discount insurance" for the lawyer. Here are examples of the taxable amounts from the Treasury table and the ectual employer costs per $1,000 of group term coverage over $50,000:

For Age	Employee Is Taxed On	Employer Actually Pays
42	$ 2.76	$ 6.36
47	4.80	9.72
52	8.16	15.12
57	13.20	23.64

(ii) Group medical insurance, hospitalization and accident and health plans.[32]

It has been calculated that these insurance benefits to a practicing professional can amount to $1,200 per year in effect, tax free.

Death Benefit

At the corporation's election, it can provide an excludable death benefit of up to $5,000 free of estate tax and also free of income tax under § 101(b).[33] This is in addition to any

31. INT. REV. CODE §§ 79, 162(g) (1).
32. Treas. Reg. § 1, 162-10 (a); INT. REV. CODE OF 1954 § 106.
33. INT. REV. CODE § 101(b).

pure gifts that may be made by the corporation or non-business purposes to the widow of a valued employee.

Dividend Received Credit

Eighty-five (85) percent of most corporate dividends received by the professional corporation are excluded from income tax. This has obvious income build-up possibilities for the corporation investing in securities, but see discussion hereafter on personal holding company and accumulated earnings problems.

Medical, Dental Reimbursement Plans

A corporation may provide reimbursement for all medical and dental expenses of selected employees on a discriminatory basis, and also to their dependents at the election of the corporation, § 105(b).[34]

Sick Pay

In addition, sick pay for selected employees of up to $100 per week can be paid to employees, which sum would be deductible to the corporation, but completely excludable up to that limit from the employee's income. This can amount to $5,000 per illness per year. See § 101(d).[35]

To my knowledge, most of these features have no counterparts available to the partner in a partnership or a sole practitioner.

Shifting of Income

The professional service corporation will also permit the shifting of income from a higher to a lower bracket through the use of a fiscal year selection. Unlike a partnership year which must be the same as that for its partners, the corporation can select a year entirely different from its shareholders. For example, a calendar year lawyer and his associates could form a professional service corporation on October 1, 1970, thus cutting off their income and expense of their former part-

34. INT. REV. CODE § 105(b).
35. INT. REV. CODE § 101(d).

nership practice as of September 30. They would thereby avoid what would otherwise be the top 25 percent of their income by effectively eliminating their net income for the last three months of the year. Further savings, however, can result. If the partners are less than 10 in number and otherwise meet the requirements of Subchapter S, the corporation can initially be taxed as if it were a partnership. This will have effects on the profit sharing or pension plan contribution which have already been referred to. In any event, the new corporation will come into existence on October 1, 1970, and can elect a fiscal year that would end on June 30, 1971. In this way, another short taxable year for income will be created because the year ending June 30, 1971, will be only 9 months long. Under Subchapter S the lawyer's individual income tax return for 1971 will reflect only salary from the corporation, if any, plus the corporation's net profit for the period ending June 30, 1971.[36] Salary payments can be kept deliberately low so long as they are reasonable. After June 30, 1971, the shareholders can revoke the Subchapter S election, remove any cloud thereby imposed on the pension plan or profit sharing contributions and proceed. In short, by prudently fasioning the selection of the fiscal year and its initial duration, tax can be effectively deferred over a two-year or even longer period. On the other hand, stumbling around imprudently can cause disastrous results by bunching 23 months of income in a single year's period. So obviously this matter should be attended very closely and wisely in conjunction with a competent tax-oriented accountant.

Favorable Corporate Tax Rates

Further, it is a direct benefit to the corporation in that income is taxed at the favorable 22 percent rate on the first $25,000 of income, and 48 percent (plus surcharge if any) on amounts taxable above this sum. This compares with individual rates in excess of this on taxable income over $64,000, assuming a married lawyer, filing jointly. Care here must be exercised with respect to avoiding the double tax on dividend income under § 11(b).[37]

36. INT. REV. CODE § 1371(d).
37. INT. REV. CODE § 11(b).

Stock Options, etc.

In addition to profit sharing or pension plans, and deferred compensation arrangements under Revenue Procedure 60-31, 1960-1, Cumulative Bulletin 174, corporate employees are entitled to the benefits of stock options and stock bonuses under § 421.[38] Although these benefits have been sharply reduced by the Tax Reform Act of 1969, nonetheless they are still available and might be quite valuable in specific cases.

Simplified Expense Reporting

With respect to tax reporting, the lawyer's job of tax expense reporting may be considerably simplified as an employee of a professional corporation. Wherever his expenses are reimbursed by the professional corporation and he makes an adequate accounting, the employee can merely check a box on his tax return. If the lawyer receives a per diem allowance on overnight business travel, he will generally be considered to have made an adequate accounting if the per diem is not more than $25 per day or 125 percent of the per diem allowance allowed government employees in the area, whichever is greater.

Auto Expense Benefit

Automobile expenses may also give the attorney a break. If he is reimbursed by the corporation for business use of his personal automobile, he has "adequately accounted" if the reimbursement is 15 cents per mile or less.[39] On the other hand, a self-employed attorney deducting his own automobile expense can deduct a maximum of ten (10) cents per mile for the first 15,000 miles and seven (7) cents per mile thereafter, unless he specifically itemizes and justifies the expense.[40]

Moving Expenses

With respect to moving expenses from one area to another, these are substantially liberalized in the Tax Reform Act of

38. INT. REV. CODE § 421.
39. REV. RUL. 63-13, 1963, 1 CUM. BULL. 69 *modified,* REV. RUL. 65-212, 1965, 2 CUM. BULL. 84.
40. REV. RUL. 66-10, 1966, 1 CUM. BULL. 622.

1969 and recognized as a legitimate corporate expense without adverse expenses to the employee. On the other hand a self-employed professional does have benefits here also, although he has tougher rules to contend with.

Consideration and Procedures of Professional Incorporation

Once the decision is made to incorporate, several considerations present themselves at the threshold. We have already referred to selection of the fiscal year, which is of cardinal importance. In addition, we have alluded in passing to the Subchapter S election.

Tax-Free Exchange of Assets for Stock

Under Section 351 of the Code,[41] persons may transfer property to a corporation solely in exchange for stock and there will be no recognition of gain or loss on the transfer if they are in control of the corporation immediately after the transfer. Control for this purpose means ownership of stock holding at least eighty (80) percent of the total combined voting power of all classes of stock entitled to vote. When such a transfer is made under § 351, the corporation takes over the basis that the transferors had in the property, and in any event is not taxable for federal tax purposes. Technically, this means partnership assets are distributed to the partners who then transfer them individually to the corporation for stock issued to them personally. The partnership need not be immediately dissolved and liquidated. In fact, we suggest it not be immediately liquidated.

Accounts Receivable/Accounts Payable

The first question then has to do with the accounts receivable—what should be done with them? A considerable body of opinion indicates that the safest thing to do with the accounts receivable is to retain them in the old partnership and have them paid to the old partners after accounts payable and terminal expenses are paid. Most partnerships being on

41. INT. REV. CODE OF 1954 § 351(a).

a cash basis, this is probably the simplest and safest course of action. If the accounts receivable are transferred to the new corporation, there is a possibility (however slight) that the professional corporation will be taxed on the amounts when it collects them or even might it be held under an assignment of income theory that the transferor remains liable for the tax also. In my view, lawyers have a choice in the matter and may with some safety transfer their accounts receivable to the new corporation without adverse tax consequence. The advantage in doing so is in a smoother cash flow for the new corporation. The question however remains open, but the safest course of action is to retain the accounts receivable, and have the former partners lend the corporation its start-up funds from the receivables as they collect them.

With respect to accounts payable, what should be done with them? Suppose these also are transferred to the new corporation and the transferors were on a cash basis and therefor had not taken a tax deduction for the unpaid payables. To avoid any question that these accounts payable should be capitalized and not deducted, the safest course here also is to have the old predecessor partnership pay the accounts payable as the accounts receivable are received, and thereby insure that the former partners will be able to deduct them properly on their individual income tax returns.

Selection of Properties Transferred

Organizers of a professional corporation should be alert to the qualification to the non-recognition rule of § 351 of the Code which is provided in § 357(c).[42] Under this section a transferor of property *does* recognize gain to the extent that any liabilities assumed by the professional corporation exceed the transferor lawyers' basis in the property transferred. Since a law professional corporation receiving receivables will have a zero basis for them that will not be much help in getting around the provisions of § 357(c). Therefore, unless the law firm has sufficient other properties with a basis which equals or exceeds the amount of any liabilities assumed by the corporation, the transferor lawyers may recognize some gain

42. INT. REV. CODE OF 1954 § 357(c).

unwittingly on the transfer of the partnership assets to the professional corporation.[43] Should, for example, real estate be transferred, or retained by the partners who may then take the depreciation personally. Also there is the question of valuation of properties transferred. This certainly should be established by appraisal at the time of the transfer.

Work in Progress/Goodwill/Name

Work in progress should be valued realistically (but on the low side) and with goodwill and name transferred to the new corporation. A reasonable valuation reached at arm's length by the partners will normally be accepted by the IRS. Name and goodwill are non-depreciable assets so remain locked in the corporation. Their initial valuation can be quite significant later on redemption of a retiring lawyer's shares when the agreement ascribes a low value to the shares, in conjunction with a deferred compensation agreement whose payments are deductible to the corporation. Keep in mind that payment by the corporation to redeem its own shares is non-deductible by it.

Partial Checklist for Incorporation

Attachment Two is a partial checklist of considerations and procedures on incorporating that may be a useful point of departure. Attachment three is a sample of our firm's Articles of Incorporation duly filed and registered with all interested persons and parties. They follow closely the model form circulated by the State Bar, and while brief are adequate to do the job.

If these are the advantages and considerations on incorporating a professional corporation, what about the other side of the coin? What are the disadvantages of incorporation. Once again, these can be divided into non-tax considerations and tax considerations. We will consider the so-called non-tax costs and disadvantages first.

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43. *See* Raich, 46 T.C. 604 (1966); REV. RUL. 69-442, 1969 INT. REV. BULL. 34.

COSTS AND DISADVANTAGES OF INCORPORATION

Increased Costs of Doing Business

Start-Up and Overhead Costs

The initial cost of establishing the corporation, preparing the various agreements, providing accounting assistance, preparing and submitting the profit sharing or pension plan, have been reasonably estimated to be somewhere in the area of \$2,000 to \$3,500. While some of this naturally includes in-house fees or costs, so to speak, nonetheless the out-of-pocket figure in either terms of lost productive time or dollar outlay is a significant sum. In addition, there will be costs of maintaining the corporation, preparation of state and federal income tax returns, etc. It is generally agreed that it costs more to service a professional corporation than it does to service a law partnership. How much more will vary greatly. A rule of thumb is that net additional operating costs will increase \$300 per lawyer per year in smaller professional corporations, with the cost per lawyer tending to decrease as the size of the firm increases.

Local and Employment Tax Increases

In addition to federal income tax (whether or not Subchapter S is elected), there will probably be an imposition of state and/or municipal franchise and income taxes. In California, for example, these amount to approximately 7.5 percent of taxable income.

There will be a change and probably an increase in payroll taxes, Social Security, Workmen's Compensation and Disability applicable to the stockholder employees. On the other hand, as previously mentioned, this represents a shift to the corporation of these expenses which may be personally borne at the present time by the partners.

Malpractice Insurance Premiums

There may be an increase in malpractice insurance premiums due to practicing law in a professional corporation; this will have to be investigated for each specific firm.

Creation of Tensions and Conflicts

On incorporating the practice, certain questions will arise that would otherwise perhaps not arise at all. For example, if the firm does not have a meaningful profit sharing or pension plan, on incorporating certain real conflicts of interest must be faced. There is no real controversy about the fact that the younger practitioners are favored by a profit sharing plan and the older practitioners looking to an earlier retirement are favored by a pension plan. The situation with regard to redemption of shares creating a non-deductible expense by the corporation is another source of controversy. In addition, since after tax income may well be reduced by as much as 10 to 30 percent in the hands of the practitioner, this means that there will be a differential impact of the corporate advantages and disadvantages on particular members of the firm. What may make most sense to the higher paid professional, will make least sense to the younger man, etc.

In addition, corporate practice undoubtedly requires a greater degree of subordinating personal self-interest than in a partnership situation. Decisions which previously were made either unilaterally, or quite informally, must now be made not only collectively but formally and reduced in the best practice to writing in the form of directors' minutes. Some highly competent professional people may simply not be temperamentally suited to operating within the ritualized procedures of the corporate form.

Tax Costs, Hazards and Disadvantages

Personal Holding Company Problems Under Section 541-543(a) (7)[44]

This concerns the receipt of income by the corporation under contract income where small law corporations are to perform personal services and some person other than the corporation has the right to designate the individual who is to perform the services. This problem can be avoided by careful wording on all contracts between the firm and its clients. However, the problem is severe because if the professional

44. INT. REV. CODE OF 1954 § 541-543 (a) (7).

corporation is deemed to be a personal holding company, its income is taxed at the rather formidable rate of 70 percent on the undistributed income. This problem is not confronted where either Subchapter S is elected or where the client retains the professional corporation as such rather than the particular attorney, and the professional corporation selects the lawyer to work on the matter. In any event, the 70 percent tax applies only to corporate income which is retained and not distributed. Hence, the simplest solution to this problem is to emphasize the distribution of income rather than accumulating it in the corporation.

Imputation of Corporate Income to the Practitioner Personally

In *Borge v. Commissioner,*[45] the corporation was simply disregarded where it incurred losses in a separate business which were used to offset professional fees and income. Under § 482 of the Code[46] the Commissioner was permitted simply to reallocate income to the shareholder that otherwise would have been imposed upon the corporation.

It has been argued that under § 269 of the Code[47] a professional corporation may be attacked on the basis that its principal purpose was tax avoidance and/or evasion. The best way to invite such an attack by the Internal Revenue Service, it is suggested, is to simply ignore the ritual and formalities of corporate separateness with respect to personal expenses, loans between the individual and the corporation, and in general to act is if the corporation didn't exist. See *Commissioner v. Laughton,*[48] *Richard Rubin,*[49] *Hogle v. Commissioner.*[50] This will be discussed more later.

Collapsible Corporation Problems

Collapsible corporation problems may arise under § 341.[51] A corporation is collapsible if a substantial portion of its as-

45. 405 F.2d 673 (2d Cir. 1968).
46. INT. REV. CODE OF 1954 § 482.
47. *Id.* at 269.
48. 113 F.2d 103 (9th Cir. 1940).
49. 51 T.C. 27 (1968).
50. 132 F.2d 66 (10th Cir. 1947).
51. INT. REV. CODE OF 1954 § 341.

sets are unrealized receivables, as is true in most law firms. Redemptions or trades of professional corporation stock may be taxed at ordinary income rather than capital gain rates.

Unreasonable Salary Problems

Reasonable salaries versus unreasonable salaries can present an issue. This arises from the fact that only reasonable compensation may be deducted by the corporation under § 162(a) (1).[52] Past salaries may be a guide, but realistically some lawyers are paid more for past services, prestige and intangibles unrelated to the amounts clients have been charged for their services. The IRS may challenge these salaries as unreasonable or as a repayment of goodwill which is not deductible to the corporation, or as a non-deductible dividend. On the other hand, it has been held that no salary is unreasonable to the extent that the salaries of all doctors did not exceed the gross billings to patients for services rendered (*Klamath Medical Service Bureau v. Commissioner*.[53]

Accumulated Earnings Tax

Under §§ 531-37 of the Code there is a special penalty tax of 27½-38½ percent on accumulated earnings in the corporation in excess of its reasonable needs over $100,000.[54] Broadly speaking the corporation is required to pay a punitive tax if it is used to avoid income tax on dividends by unreasonably accumulating rather than distributing unneeded funds to its shareholders. This only concerns accumulations in excess of $100,000. Only unreasonable accumulations are affected. Thus, if a showing can be made that the accumulation over $100,000 is for the acquisition of a new building in which to practice law, or something of that nature, the accumulation can be justified. But there is a risk here in merely accumulating funds at the lower income tax rates applicable to corporations if it is done without awareness of the consequence. Here are some examples of "good" reasons for accumulation of earnings over $100,000:

52. INT. REV. CODE OF 1954 § 162(9) (1).
53. 261 F.2d 842 (9th Cir. 1958).
54. INT. REV. CODE OF 1954 §§ 531-537.

(a) Finance additional business directly related to existing business;

(b) Liquidate mortgage or other long-term debt;

(c) Buy life insurance on key employees.

Here is an example of "insufficient" reasons:

(a) Accumulation to redeem stock of majority shareholder; but if for redemption of stock of minority shareholder if it serves corporate rather than shareholder interests; *Oman Construction Co.*,[55] *Shaw-Walker Co.*[56]

Double Taxation Problem

The double tax problem is of course an obvious one. Unless compensation and other expenses are fully deducted by the corporation to reduce income, any return of corporate income to shareholders in the form of dividends, absent a Subchapter S election, is in effect taxed twice, once at the hands of the corporation and again as a dividend on receipt by the shareholder. This is quite obvious and will not be labored here. Prudent tax planning, however, can minimize greatly this prospect.

Business Expense Versus Personal Expense Problem

Most attorneys incur a number out-of-pocket business expenses during the year such as meals and lodging, transportation, and so forth. The self-employed proprietor or partner can deduct all such business expenses in arriving at his adjusted gross income, and then in addition can choose between taking the standard deduction or itemizing his personal expenses and deducting them to arrive at taxable income. An employee taxpayer however can deduct only certain types of business expenses if he elects the standard deduction. Other business expenses which a lawyer might incur can be deducted only if he itemizes his deductions and cannot be taken in addition to the standard deduction. This would be true, for example, in the case of unreimbursed malpractice insurance pre-

55. 224 CCH T.C.M. 1799, 1810 (1965).

56. 24 CCH T.C.M. 1709, 1735 (1965) *vacated* and *remanded* 390 F.2d 205 (6th Cir. 1968).

miums, professional organizational dues, education, etc. With the liberalization of the new standard deduction increasing to 15 percent of adjusted gross income by 1973, this can be of some significance.

Roubik v. Commissioner Problems

Hazards of general operations without conforming with the niceties and rituals of corporate existence are pointed out in the recent case of *Roubik v. Commissioner,*[57] which readily raises a red flag to all professionals considering practice in the form of a professional corporation. In this case several radiologists who formerly practiced privately but who banded together in a loose confederation or association decided to form a professional corporation and then promptly to either disregard it or operate around the fringes of it. They did several things which the Court seized on as determinative of the fact that they were not practicing truly in the corporate form. While income was deposited in a corporate account, the account was maintained on a separate basis. The corporation had elected to be taxed under Subchapter S, and so all of the corporation's net income was passed through to the doctors basically based upon their own identifiable deposits less expenses. The corporation owned no equipment, incurred no debt for rent, office or medical supplies or even for salaries. In effect, the corporation was a non-entity for operating purposes and rendering professional services. The Court therefore held that it should be disregarded, and increased the doctor's income by disallowing pension plan contributions, insurance premiums, and Social Security taxes. In effect, the case is a classic how-not-to-do-it and will undoubtedly be used by the IRS in attacking professionals who practice tokenism in their corporate affairs.

Allocation of Profit and Loss Limited Within a Corporation

Commonly some professional partnerships may change the profit and loss sharing ratios of the partners even at year end when results are generally known. Corporations do not have this degree of flexibility. While increases and decreases

57. 53 T.C. 36 (1970).

Land & Water Law Review, Vol. 6 [1970], Iss. 2, Art. 11

may be made in salaries of professional people, this may not be good enough. Also continual tinkering with salaries, especially at year end, can lead the IRS to claim that these represent non-deductible dividends rather than salary adjustments.

Corporation May Make Ownership Changes of Stock More Difficult

Some law firms experience repeated changes in partners, or partnership interests. Such changes can be made in a partnership situation with no tax consequences whatever. A two-man partnership, for example, can give an employee a 10 percent interest in future profits without the employee contributing any capital. This is not a taxable transaction, as such. If, however, the lawyers were practicing as a professional corporation, such a transaction would create tax consequences. The newly admitted practitioner would have to buy his interest from the corporation or from the other shareholders because if he is given the interest free or for less than market value, the free portion of the interest transferred could be considered taxable compensation at ordinary income rates. If the shareholders, on the other hand, sell part of their interest to him at fair market value, they may have to pay a capital gain tax. In short, there may be this kind of loss of flexibility in the corporate structure.

Operating Procedures and Hazards

Depending on the persons and personalities involved, many lawyers may simply be temperamentally unsuited to operating in the corporate form. They may be so used to doing business and practicing law in their own style, that expecting them to observe corporate niceties may prove futile. The corporation, however, because it enjoys very real tax advantages to the practicing professional, can almost take for granted an audit by the Internal Revenue Service. Although the IRS has conceded certain basic points in the battle against the incorporated professional, by no means has it given up the ghost. If there is any "hanky panky" with respect to merging of personal and professional expenses, any failure or deliberate refusal to observe corporate niceties with respect to assignment of leases, retainer contracts, convening meetings of the directors for the making of corporate decisions, you are promised, in my view, a heavy price to pay for these defaults. Certainly you should expect the IRS to attack the professional corporation where the corporate rituals are conveniently ignored or disregarded. Even more care than is presently the case must be taken to maintain the integrity of corporate books and records. The lawyer as a client must be carefully educated as to the new realities of the professional corporation. Diverting funds of the corporation (however innocent), the making of loans back and forth between individual shareholders and the corporation, will certainly be noted when the IRS attack is pressed. With the decision in *Roubik,*[58] previously referred to, the battle plan of the IRS has already been laid out. It is the *bona fides* of the corporate existence itself which will be challenged by the IRS in its new assault.

Termination Problems
Disadvantage to Corporation on Buy-Out of Retiring Practitioner

Possibly the most significant tax disadvantage concerns the tax rules applicable in disposing of a professional person's interest in the professional corporation. As some of you know, the Code provides[59] that when a partner in a law firm disposes of his interest, there is an option available to the retiring partner and to the partnership. The parties can elect whether to treat a portion of the payment to him as goodwill, for which there is no deduction to the practicing partners and which is capital gain to the retiring partner, or to treat the primary portion of the payment to the retiring shareholder as payment in respect of future income for which the practicing partners will enjoy a deduction from the income tax and upon which the retiring partner will pay ordinary income. Since the retiring partner normally will have less income subsequently, it is generally the practice, subject to bargaining power, that the retiring partner will receive a substantial portion of his payments in the form of ordinary income. On the

58. *Id.*
59. INT. REV. CODE OF 1954 § 736(a).

other hand, in redeeming a stockholder's shares in a professional corporation, normally this will be treated as return of capital and capital gain to him which, of course, does not allow a deduction by the corporation or by the practicing attorneys. The advantageous provisions of allowing partnership lawyers a choice under Code[60] § 736(a) are simply not available to members of a professional corporation. In a large law firm, or one in which the sums are considerable, this provision can be extremely disadvantageous to partners considering professional incorporation, particularly where in a short time a major retirement or reorganization is contemplated.

On the other hand, by the use of a deferred compensation arrangement, much of this problem may be solvable. A reasonable but low valuation of the stock will be non-deductible to the corporation, and the sweetener can be paid to the retiring shareholder or his estate over a period of years, deductible to the corporation, but ordinary income to him. Obviously, this is not as satisfactory as § 736(a),[61] but may be useful.

Corporation or personal gain on redemption

Any gain on the redemption by a corporation of all of the stock of a shareholder may be taxed at capital gain rates pursuant to Section 302(b)(3).[62] A cross purchase by other shareholders may also result in capital gain. If redemption by the corporation relieves the remaining shareholders of an obligation of purchasing the stock of the retiring shareholder, the redemption could also result in income to the former shareholder on a discharge of indebtedness theory. (See *Wall v. United States*[63]).

Death of a Shareholder

The fair market value of the stock of a practitioner is, of course, includable in his gross estate[64] (Section 2033) and

60. *Id.*
61. *Id.*
62. INT. REV. CODE OF 1954 § 302(6)(3).
63. 164 F.2d 462 (4th Cir. 1947).
64. INT. REV. CODE OF 1954 § 2033.

has a fair market value basis for income tax purposes[65] (Section 1014(a)). Note under most professional corporation statutes the stock of a deceased practitioner must be sold or transferred to the corporation or to another licensed shareholder promptly, or the corporation will become disqualified from the practice of law.

The death of a shareholder of a Subchapter S corporation can cause unique problems. Under the provisions of Subchapter S, unless the executor of the decedent's estate consents to the subchapter election within 30 days after he qualifies as executor, the election is lost. It is irretrievably lost, even if inadvertent.[66]

Liquidation Problems

Suppose the corporate form proves unsatisfactory. Changing back to a partnership form may prove quite expensive. Complete liquidation is a taxable event, even though the shareholders intend to carry on business in another form. Amounts received by the shareholders in complete liquidation are generally capital gain.[67] No gain or loss is normally realized by the corporation under Section 336[68] except for (i) ordinary income on any depreciation recapture; (ii) ordinary income from the distribution of accounts receivable by a cash basis corporation realized when income is collected, or if the corporation is dissolved before that time when the accounts are distributed. See *Cummins Diesel Sales v. U.S.,*[69] *Saul C. Siegel Prod., Inc.*[70] If the professional corporation is liquidated and the professionals continue their practice individually, it is also possible that the Treasury will claim that each of the former stockholders received a liquidating distribution of good will that should be taxable to them as a capital gain. It will not matter that the good will was created before incorporation by the very same individuals who became shareholders. If the incorporation was tax free (as it generally

65. INT. REV. CODE OF 1954 § 1014(a).
66. INT. REV. CODE OF 1954 § 1371-1379.
67. INT. REV. CODE OF 1954 § 331.
68. INT. REV. CODE OF 1954 § 366.
69. 263 F. Supp. 677 (D. Colo. 1967).
70. 46 T.C. 15 (1966).

will be) any pre-incorporation good will contributed to the corporation will not have been taxed then.

"Sex and the Solo Practitioner"

At the outset it should be stated that to date there have been no determinations by the courts with respect to the propriety of a one-man professional corporation. There is certainly some doubt on the future of the one-man professional corporation, even though Internal Revenue Service has approved retirement plans where the only participant is the sole owner employee of the corporation.[71] Whatever problems may have previously been referred to as concerning the professional corporation, e.g. personal holding company, accumulated earnings, *Roubik,* etc., are even more aggravated in the case of the solo shareholder, especially the personal holding company and *Roubik* problems. A solo practitioner's best course of action in his corporation is to declare himself a bonus and get his dollars out rather than to accumulate funds in the corporation in excess of $100,000. Further, in all contracts with clients he should reserve the right to utilize both employees and independent contractors in the rendition of professional services. This is the area where we can expect the greatest attack by the Treasury in disregarding the corporate entity, finding discrimination in retirement plans, seeking to prove substance over form, and reassign income.

Some tax advisors see the risks as so great that they have stated that incorporation by a single practitioner-shareholder is an ill-advised adventure to the poorhouse via the Courthouse. These people say that only where exceptional situations justify it, should the risks be taken.

Statutory Uncertainties in the Future

Whatever federal tax advantages presently obtained by virtue of the professional corporation may be writ in wet sand. Already the Tax Reform Act of 1969 has eliminated many of the truly advantageous features of the pension and profit sharing retirement plans. The primary one was the complete

71. REV. RUL. INT. REV. BULL. NO. 55-81.

elimination of capital gain treatment on the employer contribution to these plans. Major "damage" was also done to Subchapter S corporations of every kind, including Subchapter S professional corporations.[72] The chances are said to be quite good that legislation will be proposed in the near future by the Treasury to reduce the tax advantages from practicing in the professional corporate form. It may be noted that the Senate Finance Committee proposed a provision in 1969 which would have severely limited the pension and profit sharing plan tax advantages of all professional corporations. This provision was strongly endorsed by the Treasury but ultimately rejected by the Senate. Future legislation undoubtedly is presently being prepared by Treasury to continue this attack, which as noted earlier, characterizes the Treasury's attitude of long standing that there is something "gimmicky" or "evil" about a professional corporation *per se*.

CONCLUSION

As the tax burden on the professional seems to be ever increasing, it is no longer desirable but indeed rapidly becoming mandatory for the lawyer to take advantage of all legitimate opportunities to minimize his tax burden. For years the facts of life were against the lawyer who could not incorporate, where his similarly situated client could do so. The professional corporation is one which should prove a worthwhile vehicle for attorneys to achieve substantial income tax and substantial estate tax savings. This is not to say that there are not certain risks and disadvantages in incorporating. These have been laid out in some detail. But on balance, and especially because of the non-tax feature of limited personal liability, your speaker strongly recommends that the lawyer with a reasonable number of practice years ahead, form a professional corporation with his practicing colleagues.

PARTIAL CHECKLIST ON INCORPORATING PRACTICE

1. Select name reflecting corporate status, fictitious name compliance.

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72. INT. REV. CODE OF 1954 §§ 1371-1379.

2. Decide what properties or leases to be transferred to new corporation and which are to be held individually. Get any appraisals necessary.
3. Review all insurance.
4. Consult with tax accountant re:
   - (a) Taxable Year
   - (b) Depreciation and Amortization
   - (c) Subchapter S
   - (d) Section 1244
   - (e) Decide on accounts receivables, payables
   - (f) Forecast cash needs for first six months
5. Draft preliminary documents.
   - (a) Instrument transferring partnership assets to partners.
   - (b) Corporate purchase agreements, Bills of Sale
   - (c) Leases, assignments of leases
   - (d) Corporate retainer contracts
   - (e) Buy-sell agreements
   - (f) Employment contracts with lawyers
   - (g) Insurance arrangements or guaranty agreements of shareholders
6. Prepare Articles.
7. Prepare By-Laws.
8. File Articles with state.
9. Hold first meeting of directors.
   - (a) Adopt resolution determining fair market value of property for which stock and paid-in surplus paid.
   - (b) Adopt resolutions fixing salaries of officers, approving employment contracts with officers or other employees.
   - (c) Adopt tax resolutions.

(d) Authorize amortization of incorporation expense.

(e) Adopt plan to issue stock under Section 1244, which will qualify for favorable tax loss treatment.

(f) Authorize Subchapter S election.

(g) Adopt tax year.

(h) Authorize adoption of pension or profit-sharing plan.

(i) Adopt insurance, medical, thrift plans.

10. Order corporate seal, stationery, etc., share certificates.
11. Prepare and submit application for issuance of certificate of registration to state bar.
12. Issue stock.
13. Complete formalities of leases, assignments, contracts, Subchapter S, state tax agencies, IRS approvals of pension/profit sharing plans.

Attachment III

ARTICLES OF INCORPORATION
of
SILVER, ROSEN & JOHNSON
Professional Corporation

FIRST: The name of this corporation shall be:

SILVER, ROSEN & JOHNSON
Professional Corporation

SECOND: The corporation's purposes are:

(a) Primarily to engage in the specific business of the practice of law as a law corporation;

(b) To engage generally in the business of a law corporation as the same is now or hereafter defined by statute, rule and regulation, and in connection therewith to own property, to enter into contracts, and to transact any lawful business related thereto;

(c) To engage in such other businesses as may be authorized or permitted by the California General Corporation Law and Business and Professions Code. This corporation is a professional corporation within the meaning of Part 4 of Division 3 of Title 1 of the California Corporations Code.

THIRD: The county in the State of California where the principal office for the transaction of the business of the corporation is located is the County of San Francisco.

FOURTH: The number of directors of the corporation is three (3), until otherwise provided by a by-law duly adopted by the shareholders. The names and addresses of the persons who are appointed to act as first directors are:

BERTRAM S. SILVER
147 Mendosa Avenue
San Francisco

MARTIN J. ROSEN
317 Rydal Drive
Mill Valley

ELDON M. JOHNSON
1660—18th Avenue
San Francisco

FIFTH: Each director and each officer of the corporation shall be an active member of the California State Bar.

SIXTH: The shares of the corporation may be owned only by:

(a) The corporation; or

(b) By an active member of the State bar who:

(i) Is an employee or retired employee of the corporation and is not a director, officer, or shareholder of any other law corporation; and

(ii) Does not practice law except on behalf of the corporation; provided, however, a member may be a shareholder although he acts as attorney pursuant to court order, or acts on behalf of a legal aid or similar organization, or is associated or employed as an attorney by another active member, law partnership, or law corporation.

SEVENTH: The shares of the corporation owned by a person who:

(a) dies;

(b) ceases to be an eligible shareholder, or

(c) becomes a disqualiifed person as defined in § 13401(d) of the Corporations Code, for a period exceeding 90 days,

shall be sold and transferred to the corporation or its shareholders on such terms as are agreed upon by the corporation and its shareholders. Such sale or transfer shall occur not later than six months after any such death and not later than 90 days after the date he ceases to be an eligible shareholder, or 90 days after the date he becomes a disqualified person.

EIGHTH: The share certificates of the corporation shall contain an appropriate legend setting forth the restrictions of share ownership mentioned in paragraphs SIXTH and SEVENTH above.

NINTH: The income of the corporation attributable to its practice of law while a shareholder is a disqualified person shall not in any manner accrue to the benefit of such shareholder or his shares.

TENTH: The total number of shares which the corporation is authorized to issue is 10,000 shares. The aggregate par value of said shares is $100,000.00, and the par value of of each share is $10.00. No distinction shall exist between the shares of the corporation or the holders thereof.

IN WITNESS WHEREOF, the undersigned incorporators including the first directors of this corporation have executed these Articles of Incorporation on

BERTRAM S. SILVER

MARTIN J. ROSEN

ELDON M. JOHNSON

STATE OF CALIFORIA)
) ss
CITY AND COUNTY OF SAN FRANCISCO)

On May 27, 1969, before me, a Notary Public in and for said City, County and State, personally appeared BERTRAM S. SILVER, MARTIN J. ROSEN, and ELDON M. JOHNSON, known to me to the persons whose names are subscribed to the foregoing articles of incorporation, and acknowledged to me that they executed the same.

WITNESS my hand and official seal.

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